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**ANNUAL AUDITED REPORT  
FORM X-17A-5 (A)  
PART III**

SEC FILE NUMBER  
8. 38325

FACING PAGE

**Information Required of Brokers and Dealers Pursuant to Section 17 of the  
Securities Exchange Act of 1934 and Rule 17a-5 Thereunder**

REPORT FOR THE PERIOD BEGINNING 01/01/2009 AND ENDING 12/31/2009  
MM/DD/YY MM/DD/YY

**A. REGISTRANT IDENTIFICATION**

NAME OF BROKER-DEALER: Sanders Morris Harris Inc. (formerly SMH Capital,  
Inc.)

OFFICIAL USE ONLY  
FIRM I.D. NO.

ADDRESS OF PRINCIPAL PLACE OF BUSINESS: (Do not use P.O. Box No.)

600 Travis Street, Suite 5800

(No. and Street)

Houston, Texas 77002

(City)

(State)

(Zip Code)

NAME AND TELEPHONE NUMBER OF PERSON TO CONTACT IN REGARD TO THIS REPORT  
George L. Ball (713) 224-3100

(Area Code - Telephone Number)

**B. ACCOUNTANT IDENTIFICATION**

INDEPENDENT PUBLIC ACCOUNTANT whose opinion is contained in this Report\*

Grant Thornton LLP

(Name - if individual, state last, first, middle name)

333 Clay Street, 27th Floor, Houston, Texas 77002

(Address)

(City)

(State)

(Zip Code)

**CHECK ONE:**

- Certified Public Accountant
- Public Accountant
- Accountant not resident in United States or any of its possessions.

**FOR OFFICIAL USE ONLY**

\*Claims for exemption from the requirement that the annual report be covered by the opinion of an independent public accountant must be supported by a statement of facts and circumstances relied on as the basis for the exemption. See Section 240.17a-5(e)(2)

4/13

OATH OR AFFIRMATION

I, George L. Ball, swear (or affirm) that, to the best of my knowledge and belief the accompanying financial statement and supporting schedules pertaining to the firm of Sanders Morris Harris Inc. (formerly SMH Capital, Inc.) of December 31, 20 09, are true and correct. I further swear (or affirm) that neither the company nor any partner, proprietor, principal officer or director has any proprietary interest in any account classified solely as that of a customer, except as follows:

[Handwritten signature of George L. Ball]

Signature

George L. Ball, Chief Executive Officer

Title

[Handwritten signature of Stephanie D. Crissey]  
Notary Public



This report \*\* contains (check all applicable boxes):

- (a) Facing Page.
(b) Statement of Financial Condition.
(c) Statement of Income (Loss).
(d) Statement of Changes in Financial Condition.
(e) Statement of Changes in Stockholders' Equity or Partners' or Sole Proprietors' Capital.
(f) Statement of Changes in Liabilities Subordinated to Claims of Creditors.
(g) Computation of Net Capital.
(h) Computation for Determination of Reserve Requirements Pursuant to Rule 15c3-3.
(i) Information Relating to the Possession or Control Requirements Under Rule 15c3-3.
(j) A Reconciliation, including appropriate explanation of the Computation of Net Capital Under Rule 15c3-1 and the Computation for Determination of the Reserve Requirements Under Exhibit A of Rule 15c3-3.
(k) A Reconciliation between the audited and unaudited Statements of Financial Condition with respect to methods of consolidation.
(l) An Oath or Affirmation.
(m) A copy of the SIPC Supplemental Report.
(n) A report describing any material inadequacies found to exist or found to have existed since the date of the previous audit.

\*\*For conditions of confidential treatment of certain portions of this filing, see section 240.17a-5(e)(3).

Consolidated Financial Statements and  
Supplemental Schedule Pursuant to Rule 17a-5  
of the Securities and Exchange Commission with  
Report of Independent Registered Public  
Accounting Firm

**Sanders Morris Harris Inc.**  
**(formerly SMH Capital Inc.)**

For the Year Ended December 31, 2009

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# Grant Thornton

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## Report of Independent Registered Public Accounting Firm

The Board of Directors  
Sanders Morris Harris Inc. (formerly SMH Capital Inc.)

We have audited the accompanying consolidated statement of financial condition of Sanders Morris Harris Inc. (a Texas corporation) (a wholly owned subsidiary of Sanders Morris Harris Group Inc.) and subsidiaries (collectively, the "Company") as of December 31, 2009 and the related consolidated statements of operations, changes in equity, and cash flows for the year then ended that you are filing pursuant to Rule 17a-5 under the Securities Exchange Act of 1934. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America as established by the American Institute of Certified Public Accountants and in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Sanders Morris Harris Inc. and subsidiaries as of December 31, 2009 and the results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note B, the consolidated financial statements of the Company as of and for the year ended December 31, 2009 have been restated to correct the classification of the gain on the disposition of the Capital Markets Business.

Our audit was conducted for the purpose of forming an opinion on the basic consolidated financial statements taken as a whole. The information contained in the supplemental schedule is presented for purposes of additional analysis and is not a required part of the basic consolidated financial statements, but is supplementary information required by Rule 17a-5 under the Securities Exchange Act of 1934. Such information has been subjected to the auditing procedures applied in the audit of the basic consolidated financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic consolidated financial statements taken as a whole.

*Grant Thornton LLP*

Houston, Texas

February 26, 2010, except for Note B, Note D,

Note H, and Note R, for which the date is March 23, 2010.

**Sanders Morris Harris Inc. (formerly SMH Capital Inc.)**

**CONSOLIDATED STATEMENT OF FINANCIAL CONDITION**

December 31, 2009

(In thousands, except share and per share amounts)

| <b>Assets</b>  |                         |
|--|-------------------------|
| Cash and cash equivalents  | \$ 21,040               |
| Deposits with clearing organizations   | 2,527                   |
| Receivables, net   | 16,188                  |
| Securities owned:  |                         |
| Marketable   | 12,461                  |
| Not readily marketable   | 12,443                  |
| Furniture, equipment, and leasehold improvements, net  | 9,722                   |
| Other assets   | 3,405                   |
| Receivable from Parent, affiliates, and subsidiaries, net  | 5,777                   |
|  | <hr/>                   |
| Total assets   | <u><u>\$ 83,563</u></u> |
| <br><b>Liabilities and Equity</b>  |                         |
| <b>Liabilities:</b>  |                         |
| Securities sold, not yet purchased, at market value  | \$ 8,339                |
| Payable to broker-dealers  | 23                      |
| Accounts payable and accrued liabilities   | 8,825                   |
| Sales commissions and bonuses payable  | 4,078                   |
| Deferred compensation  | 513                     |
| Deferred tax liability, net  | 2,399                   |
|  | <hr/>                   |
| Total liabilities  | <u>24,177</u>           |
| <br>Commitments and contingencies  |                         |
| <b>Equity:</b>   |                         |
| Common stock, \$0.01 par value; 200,000 shares authorized;<br>60,729 shares issued and outstanding | 1                       |
| Additional paid-in capital   | 60,032                  |
| Accumulated deficit  | (3,394)                 |
|  | <hr/>                   |
| Total Sanders Morris Harris Inc. stockholder's equity  | <u>56,639</u>           |
| Noncontrolling interest  | 2,747                   |
|  | <hr/>                   |
| Total equity   | <u>59,386</u>           |
|  | <hr/>                   |
| Total liabilities and equity   | <u><u>\$ 83,563</u></u> |

The accompanying notes are an integral part of this statement.

**Sanders Morris Harris Inc. (formerly SMH Capital Inc.)**

**CONSOLIDATED STATEMENT OF OPERATIONS (RESTATED)**

Year Ended December 31, 2009

(Dollars in thousands)

|  |            |
|--|------------|
| Revenue:   |            |
| Commissions  | \$ 42,263  |
| Investment banking   | 2,455      |
| Investment advisory and related services   | 9,729      |
| Principal transactions, net  | 31,843     |
| Interest and dividends   | 2,233      |
| Other income   | 6,098      |
| Total revenue  | 94,621     |
| Expenses:  |            |
| Employee compensation and benefits   | 65,924     |
| Communications and data processing   | 5,833      |
| Occupancy  | 7,503      |
| Clearing and execution fees  | 5,945      |
| Commissions  | 6,264      |
| Other  | 9,417      |
| Total expenses   | 100,886    |
| Loss from continuing operations before equity in loss of limited partnerships and income taxes | (6,265)    |
| Equity in loss of limited partnerships   | (192)      |
| Loss from continuing operations before income taxes  | (6,457)    |
| Benefit for income taxes   | (3,203)    |
| Loss from continuing operations, net of income taxes   | (3,254)    |
| Loss from discontinued operations, net of income taxes of \$(353)                              | (551)      |
| Net loss   | (3,805)    |
| Less: Net income attributable to the noncontrolling interest                                   | (1,934)    |
| Net loss attributable to Sanders Morris Harris Inc.  | \$ (5,739) |

The accompanying notes are an integral part of this statement.

Sanders Morris Harris Inc. (formerly SMH Capital Inc.)

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

Year Ended December 31, 2009  
(In thousands, except share amounts)

|  | Common stock |        | Additional         | Accumulated | Noncontrolling | Total     |
|--|--------------|--------|--------------------|-------------|----------------|-----------|
|  | Shares       | Amount | paid-in<br>capital | deficit     | interest       |           |
| Balance, January 1, 2009                               | 60,729       | \$ 1   | \$ 60,032          | \$ 2,345    | \$ 3,342       | \$ 65,720 |
| Net loss attributable to Sanders Morris Harris Inc.    | -            | -      | -                  | (5,739)     | -              | (5,739)   |
| Net income attributable to the noncontrolling interest | -            | -      | -                  | -           | 1,934          | 1,934     |
| Contributions  | -            | -      | -                  | -           | 40             | 40        |
| Distributions  | -            | -      | -                  | -           | (2,569)        | (2,569)   |
| Balance, December 31, 2009                             | 60,729       | \$ 1   | \$ 60,032          | \$ (3,394)  | \$ 2,747       | \$ 59,386 |

The accompanying notes are an integral part of this statement.



**Sanders Morris Harris Inc. (formerly SMH Capital Inc.)**

**CONSOLIDATED STATEMENT OF CASH FLOWS**

Year Ended December 31, 2009

(Dollars in thousands)

|   |                  |
|---|------------------|
| Cash flows from operating activities:   |                  |
| Net loss  | \$ (3,805)       |
| Adjustments to reconcile net loss to net cash provided by operating activities:         |                  |
| Depreciation  | 3,329            |
| Gain on disposal of assets  | (8,283)          |
| Provision for bad debts   | 3,039            |
| Compensation expense related to deferred charge   | 2,347            |
| Deferred income taxes   | 3,480            |
| Equity in loss of limited partnerships  | 192              |
| Unrealized and realized gains on not readily marketable securities owned, net           | (1,210)          |
| Not readily marketable securities owned received for payment of investment banking fees | (21)             |
| Net change in:  |                  |
| Receivables, net  | (2,533)          |
| Marketable securities owned   | 10,511           |
| Deposits with clearing organizations  | (1,465)          |
| Other assets  | 11               |
| Payable to broker-dealers   | (2,028)          |
| Securities sold, not yet purchased  | (4,545)          |
| Accounts payable and accrued liabilities  | 1,995            |
| Sales commissions and bonuses payable   | (3,303)          |
| Deferred compensation   | (408)            |
| Receivable from Parent, affiliates, and subsidiaries, net                               | 8,014            |
| Net cash provided by operating activities   | <u>5,317</u>     |
| Cash flows from investing activities:   |                  |
| Capital expenditures  | (1,593)          |
| Proceeds from sale of assets  | 305              |
| Proceeds from sales of not readily marketable securities owned                          | 3,029            |
| Purchases of not readily marketable securities owned                                    | <u>(2,318)</u>   |
| Net cash used in investing activities   | <u>(577)</u>     |
| Cash flows from financing activities:   |                  |
| Contributions by noncontrolling interest  | 40               |
| Distributions to noncontrolling interest  | <u>(2,569)</u>   |
| Net cash used in financing activities   | <u>(2,529)</u>   |
| Net increase in cash and cash equivalents   | 2,211            |
| Cash and cash equivalents, beginning of year  | <u>18,829</u>    |
| Cash and cash equivalents, end of year  | <u>\$ 21,040</u> |

The accompanying notes are an integral part of this statement.

**Sanders Morris Harris Inc. (formerly SMH Capital Inc.)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTROL**  
December 31, 2009

**NOTE A – ORGANIZATION**

Sanders Morris Harris Inc. (formerly known as SMH Capital Inc.) (the “Company”), a wholly owned subsidiary of Sanders Morris Harris Group Inc. (“SMHG”) is incorporated in the state of Texas for the purpose of serving as a broker/dealer and to enter into certain investment banking activities. The Company operates as an introducing broker. Its customers’ accounts are carried by several clearing firms including Pershing LLC, an affiliate of The Bank of New York Mellon, Goldman Sachs Execution & Clearing, L.P., Ridge Clearing & Outsourcing Solutions, Inc., First Clearing Corporation, and J.P. Morgan Clearing Corp., under fully disclosed clearing arrangements. These clearing brokers also provide the Company with information necessary to generate commission runs, transaction summaries, and data feeds for various reports, including compliance and risk management, execution reports, trade confirmations, monthly account statements, cashiering functions, and handling of margin accounts.

In addition, the Company manages, through its interests in certain management companies, limited partnerships that invest in debt and equity securities in small to medium capitalization companies primarily operating in the environmental, industrial services, healthcare, technology, medical, life sciences, and energy industries.

During the first quarter of 2009, the Company closed three retail offices. The operating results for these offices are included in loss from discontinued operations, net of income taxes. During the fourth quarter of 2009, the Company contributed to Madison Williams Capital, LLC (“Madison Williams”) the assets, properties, working capital, and rights related and/or pertaining to its investment banking, institutional trading (including equity sales and fixed income sales), New York trading, and research businesses (excluding The Juda Group and the Concept Capital divisions) (the “Capital Markets Business”) in exchange for a 17.5% Class A Membership Interest in Madison Williams, cash, and a note issued by Madison Williams to the Company. The operating results for the Capital Markets Business are included in loss from discontinued operations, net of income taxes.

**Sanders Morris Harris Inc. (formerly SMH Capital Inc.)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

December 31, 2009

**NOTE B – RESTATEMENT**

The Company has determined that its previously reported accounting for the disposition of the Capital Markets Business was incorrect as the gain from the sale should have been classified as discontinued operations. The result of the correction on the Consolidated Statement of Operations for the year ended December 31, 2009 is as follows:

|  | <u>As Reported</u> | <u>As Restated</u> |
|--|--------------------|--------------------|
|  | (in thousands)     |                    |
| Gain on disposal of assets   | \$ 8,283           | \$ -               |
| Other income   | 6,108              | 6,098              |
| Income (loss) from continuing operations before equity<br>in loss of limited partnerships and income taxes | 2,028              | (6,265)            |
| Income (loss) from continuing operations<br>before income taxes  | 1,836              | (6,457)            |
| Provision (benefit) for income taxes   | 31                 | (3,203)            |
| Income (loss) from continuing operations,<br>net of income taxes   | 1,805              | (3,254)            |
| Loss from discontinued operations, net of income taxes   | (5,610)            | (551)              |

**NOTE C – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**1. Principles of Consolidation**

The consolidated financial statements include the accounts of the Company and its majority-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

**2. Cash and Cash Equivalents**

For purposes of the statement of cash flows, the Company considers all highly liquid investments with original maturities of three months or less when purchased to be cash equivalents. The Company is subject to the regulations of the Securities and Exchange Commission that, among other things, may restrict the withdrawal of cash held at the Company's clearing firms that is used to collateralize the Company's trading accounts.

**3. Securities Owned**

Marketable securities are carried at market value based on quoted market prices. Not readily marketable securities are valued at fair value based on either internal valuation models or management's estimate of amounts that could be realized under current market conditions assuming an orderly liquidation over a reasonable period of time. Unrealized gains or losses from marking securities owned to fair value or estimated fair value are included in revenue under the caption "Principal transactions, net" and in "Equity in

**Sanders Morris Harris Inc. (formerly SMH Capital Inc.)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

December 31, 2009

**NOTE C – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued**

loss of limited partnerships". Securities not readily marketable include securities: (a) for which there is no market on a securities exchange or no independent publicly quoted market, (b) that cannot be publicly offered or sold unless registration is effected under the Securities Act of 1933 or other applicable securities acts, or (c) that cannot be offered or sold because of other arrangements, restrictions, or conditions applicable to the securities or to the company. Proprietary securities transactions and the related income/expense are recorded on the trade date. Realized gains and losses from sales of securities are computed using the average cost method.

Investments in not readily marketable securities, marketable securities with insufficient trading volumes, and restricted securities have been valued at their estimated fair value by the Company in the absence of readily ascertainable market values. These estimated values may differ significantly from the values that would have been used had a readily available market existed for these investments. Such differences could be material to the financial statements.

**4. Commissions**

Commissions are recorded on a trade-date basis as securities transactions occur.

**5. Furniture, Equipment, and Leasehold Improvements**

Furniture, equipment, and leasehold improvements are carried at cost less accumulated depreciation and amortization. Amortization of leasehold improvements is computed on a straight-line basis over the term of the lease. Depreciation of office furniture and equipment is computed on a straight-line basis over the average asset life which ranges from a three to seven-year period.

**6. Investment Banking**

Investment banking revenue includes gains, losses, and fees, net of expenses, arising from securities offerings in which the Company acts as an underwriter, agent, or financial advisor and fees earned as financial advisor in mergers and acquisitions and similar transactions. Underwriting management fees are recorded on the offering date; sales concessions are recorded on the settlement date; and underwriting fees are recorded at the time the underwriting is completed and the related income is reasonably determinable.

**7. Investment Advisory and Related Services**

Investment advisory and related services consist primarily of portfolio and partnership management fees. Portfolio management fees are received quarterly, and are recognized as earned when due. Partnership management fees are received quarterly, but are recognized as earned on a monthly basis.

Sanders Morris Harris Inc. (formerly SMH Capital Inc.)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

NOTE C – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued

8. Income Taxes

The Company is included in the consolidated federal return with SMHG and computes its respective tax attributes on a separate company basis.

Deferred income taxes are provided utilizing the asset and liability method, whereby deferred income tax assets or liabilities are recognized for the tax consequences in future years of differences in the tax bases of assets and liabilities and their financial reporting amounts based on enacted tax laws and statutory tax rates applicable to the periods in which the differences are expected to affect taxable income. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized.

The Company recognizes and measures its unrecognized tax benefits in accordance with Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) Topic 740, *Income Taxes*. Under that guidance, the Company assesses the likelihood, based on their technical merit, that tax positions will be sustained upon examination based on the facts, circumstances, and information available at the end of each period. The measurement of unrecognized tax benefits is adjusted when new information is available, or when an event occurs that requires a change.

9. Use of Estimates

The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

10. Risks and Uncertainties

The Company owns securities that are valued at estimated fair values or quoted market values at the consolidated statement of financial condition date. As a result of changes in market and other conditions, it is at least reasonably possible that changes to the values of securities could occur in the short term and be material to the Company’s consolidated financial statements.

11. New Authoritative Accounting Guidance

*FASB ASC Topic 320, Investments – Debt and Equity Securities*. New authoritative accounting guidance under ASC Topic 320, *Investments – Debt and Equity Securities*, (i) changes existing guidance for determining whether an impairment is other than temporary to debt securities and (ii) replaces the existing requirement that the entity’s management assert it has both the intent and ability to hold an impaired security until recovery with a requirement that management assert: (a) it does not have the intent to sell the security; and (b) it is more likely than not it will not have to sell the security before recovery of its cost basis. Under ASC Topic 320, declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be

Sanders Morris Harris Inc. (formerly SMH Capital Inc.)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

NOTE C – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued

other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses. The amount of the impairment related to other factors is recognized in other comprehensive income. The Company adopted the provisions of the new authoritative accounting guidance under ASC Topic 320 for the period ending December 31, 2009. Adoption of the new guidance did not have a material impact on the Company's consolidated financial statements.

*FASB ASC Topic 805, Business Combinations.* On January 1, 2009, new authoritative guidance under ASC Topic 805, *Business Combinations*, became applicable to the Company's accounting for business combinations closing on or after January 1, 2009. ASC Topic 805 applies to all transactions and other events in which one entity obtains control over one or more other businesses. ASC Topic 805 requires an acquirer, upon initially obtaining control of another entity, to recognize the assets, liabilities, and any non-controlling interest in the acquiree at fair value as of the acquisition date. Contingent consideration is required to be recognized and measured at fair value on the date of acquisition rather than at a later date when the amount of that consideration may be determinable beyond a reasonable doubt. This fair value approach replaces the cost-allocation process required under previous accounting guidance whereby the cost of an acquisition was allocated to the individual assets acquired and liabilities assumed based on their estimated fair value. ASC Topic 805 requires acquirers to expense acquisition-related costs as incurred rather than allocating such costs to the assets acquired and liabilities assumed, as was previously the case under prior accounting guidance. Assets acquired and liabilities assumed in a business combination that arise from contingencies are to be recognized at fair value if fair value can be reasonably estimated. If fair value of such an asset or liability cannot be reasonably estimated, the asset or liability would generally be recognized in accordance with ASC Topic 450, *Contingencies*. Under ASC Topic 805, the requirements of ASC Topic 420, *Exit or Disposal Cost Obligations*, would have to be met in order to accrue for a restructuring plan in purchase accounting. Pre-acquisition contingencies are to be recognized at fair value, unless it is a non-contractual contingency that is not likely to materialize, in which case, nothing should be recognized in purchase accounting and, instead, that contingency would be subject to the probable and estimable recognition criteria of ASC Topic 450, *Contingencies*.

*FASB ASC Topic 810, Consolidation.* New authoritative guidance under ASC Topic 810, *Consolidation*, amended prior guidance to establish accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. Under ASC Topic 810, a non-controlling interest in a subsidiary, which is sometimes referred to as minority interest, is an ownership interest in the consolidated entity that should be reported as a component of equity in the consolidated financial statements. Among other requirements, ASC Topic 810 requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the non-controlling interest in subsidiaries. It also requires disclosure, on the face of the consolidated income statement, of the amounts of consolidated net income attributable to the parent and to the non-controlling interest in subsidiaries. The new authoritative accounting guidance under ASC Topic 810 was effective for the Company on January 1, 2009. Shareholders' equity changed due to the application of the new authoritative accounting guidance. Noncontrolling interest, formerly presented as minority interests outside of shareholders' equity, is now included in equity.

Sanders Morris Harris Inc. (formerly SMH Capital Inc.)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2009

**NOTE C – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued**

Further new authoritative accounting guidance under ASC Topic 810 amends prior guidance to change how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. The determination of whether a company is required to consolidate an entity is based on, among other things, an entity's purpose and design and a company's ability to direct the activities of the entity that most significantly impact the entity's economic performance. The new authoritative accounting guidance requires additional disclosures about the reporting entity's involvement with variable-interest entities and any significant changes in risk exposure due to that involvement as well as its affect on the entity's financial statements. The new authoritative accounting guidance under ASC Topic 810 will be effective January 1, 2010 and is not expected to have a material impact on the Company's consolidated financial statements.

*FASB ASC Topic 820, Fair Value Measurements and Disclosures.* New authoritative accounting guidance under ASC Topic 820, *Fair Value Measurements and Disclosures*, affirms that the objective of fair value when the market for an asset is not active is the price that would be received to sell the asset in an orderly transaction, and clarifies and includes additional factors for determining whether there has been a significant decrease in market activity for an asset when the market for that asset is not active. ASC Topic 820 requires an entity to base its conclusions about whether a transaction was not orderly on the weight of the evidence. The new accounting guidance amended prior guidance to expand certain disclosure requirements. The new authoritative accounting guidance under ASC Topic 820 was effective for the Company for the period ending December 31, 2009 and did not have a material impact on the Company's consolidated financial statements.

Further new authoritative accounting guidance (Accounting Standards Update No. 2009-5) under ASC Topic 820 provides guidance for measuring the fair value of a liability in circumstances in which a quoted price in an active market for the identical liability is not available. In such instances, a reporting entity is required to measure fair value utilizing a valuation technique that uses (i) the quoted price of the identical liability when traded as an asset, (ii) quoted prices for similar liabilities or similar liabilities when traded as assets, or (iii) another valuation technique that is consistent with the existing principles of ASC Topic 820, such as an income approach or market approach. The new authoritative accounting guidance also clarifies that when estimating the fair value of a liability, a reporting entity is not required to include a separate input or adjustment or other inputs relating to the existence of a restriction that prevents the transfer of the liability. This new authoritative accounting guidance under ASC Topic 820 was effective for the Company on October 1, 2009 and did not have a material impact on the Company's consolidated financial statements.

*FASB ASC Topic 825, Financial Instruments.* New authoritative accounting guidance under ASC Topic 825, *Financial Instruments*, requires an entity to provide disclosures about the fair value of financial instruments in interim financial information and amends prior guidance to require those disclosures in summarized financial information at interim reporting periods. The new authoritative accounting guidance under ASC Topic 825 was effective for the Company for the period ending December 31, 2009 and did not have a material impact on the Company's consolidated financial statements.

**Sanders Morris Harris Inc. (formerly SMH Capital Inc.)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
December 31, 2009

**NOTE C – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – Continued**

*FASB ASC Topic 855, Subsequent Events.* New authoritative accounting guidance under ASC Topic 855, *Subsequent Events*, establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or available to be issued. ASC Topic 855 defines (i) the period after the balance sheet date during which a reporting entity's management should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, (ii) the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and (iii) the disclosures an entity should make about events or transactions that occurred after the balance sheet date. The new authoritative accounting guidance under ASC Topic 855 was effective for the Company for the period ending December 31, 2009 and did not have a material impact on the Company's consolidated financial statements.

*FASB ASC Topic 860, Transfers and Servicing.* New authoritative accounting guidance under ASC Topic 860, *Transfers and Servicing*, amends prior accounting guidance to enhance reporting about transfers of financial assets, including securitizations, and where companies have continuing exposure to the risks related to transferred financial assets. The new authoritative accounting guidance eliminates the concept of a "qualifying special-purpose entity" and changes the requirements for derecognizing financial assets. The new authoritative accounting guidance also requires additional disclosures about all continuing involvements with transferred financial assets including information about gains and losses resulting from transfers during the period. The new authoritative accounting guidance under ASC Topic 860 will be effective January 1, 2010 and is not expected to have a material impact on the Company's consolidated financial statements.

**NOTE D – DISPOSITION (Restated)**

In January 2009, SMHG and the Company entered into a Contribution Agreement with Pan Asia China Commerce Corp. ("PAC3"), Madison Williams and Madison Williams and Company, LLC ("New BD"), pursuant to which (a) PAC3 agreed to subscribe for and purchase a 40% Class A membership interest in Madison Williams in exchange for a cash payment and note and (b) the Company agreed to contribute to New BD the Capital Markets Business, including a specified amount of working capital (as adjusted for any profits or losses incurred in the Capital Markets Business between January 1, 2009, and the date of closing) less (i) the value of the accounts receivable contributed to Madison Williams, (ii) the value of the certain assets in the Company's New Orleans, Louisiana office, (iii) the value of certain money security deposits and any advance payments, and (iv) the value of certain securities to be mutually agreed upon by the parties in exchange for a 20% Class A membership interest in Madison Williams, cash, and a note issued by Madison Williams to the Company. Current members of management of the Capital Markets Business will retain the remaining 40% membership interest in Madison Williams.

On November 9, 2009, SMHG, the Company, PAC3, and Madison Williams entered into an Amended and Restated Contribution Agreement with Fletcher Asset Management, Inc. ("Fletcher"), with respect to the formation of the New BD. Pursuant to the Amended and Restated Contribution Agreement, (a) PAC3's membership interest in Madison Williams was reduced to a 3.1% Class A membership interest and 28.0% Class B membership interest, (b) the Company's interest in Madison Williams was reduced to a 17.5% Class A



**Sanders Morris Harris Inc. (formerly SMH Capital Inc.)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

December 31, 2009

**NOTE D – DISPOSITION (Restated) – Continued**

membership interest, (c) Fletcher agreed to subscribe for and purchase a 40.5% Class A membership interest in Madison Williams in exchange for a cash contribution, and (d) the interest of management of Madison Williams was reduced to a 6.5% Class B membership interest. The Class A membership interests have a distribution preference over the Class B membership interests until a total of \$8.5 million of distributions to the Class A membership interest have been made, and no distributions may be made to any class of Class B membership interests until the note for \$8.0 million has been repaid. This transaction closed on December 9, 2009. The Company recognized a gain of \$8.3 million from the sale of the Capital Markets Business which is included in "Loss from discontinued operations, net of income taxes" in the Consolidated Statement of Operations. The Company expects to receive its share of profits if and when distributions are made by Madison Williams.

**NOTE E – RECEIVABLES**

The receivables balance at December 31, 2009 consists of the following (in thousands):

|  |                  |
|--|------------------|
| Notes receivable:                                |                  |
| Nonaffiliates                                    | \$ 1,309         |
| Employees and executives                         | 2,670            |
| Other affiliates                                 | 8,000            |
| Receivables from affiliated limited partnerships | 290              |
| Receivables from other affiliates                | 324              |
| Receivables from broker-dealers                  | 1,112            |
| Receivables from investment banking              | 4,924            |
| Allowances for bad debts                         | (2,441)          |
|  | <u>\$ 16,188</u> |

Notes receivable from nonaffiliates consists of uncollateralized promissory notes from unrelated companies. The notes bear interest at various rates up to 12% and are payable on demand.

Notes receivable from employees and executives primarily consist of noninterest bearing loans provided to certain executives and employees of the Company to induce the employees and executives to affiliate with the Company. Notes receivable issued to employees totaled \$1.1 million in 2009. The notes typically are forgiven over a one to six-year period and have tiered maturities from 2010 through 2016 and are structured to be incentives for the employees to remain at the Company. As each maturity date is reached, a portion of the notes is forgiven if the employee remains employed by the Company. If employment is terminated, the remaining unforgiven balance is due and payable by the former employee. Such forgiveness is recorded as employee compensation and benefits in the consolidated statement of operations.

**Sanders Morris Harris Inc. (formerly SMH Capital Inc.)**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

**NOTE E – RECEIVABLES – Continued**

Notes receivable from other affiliates consist of the note issued by Madison Williams to the Company in connection with the Capital Markets transaction (see Note C – Disposition). This note bears interest at 6% and matures on December 9, 2019.

Receivables from investment banking customers consist of investment banking fees earned and related reimbursable expenses incurred.

**NOTE F – SECURITIES OWNED AND SECURITIES SOLD, NOT YET PURCHASED**

Securities owned and securities sold, not yet purchased, at December 31, 2009 consist of the following, at fair and estimated fair value (in thousands):

|  | Securities<br>Owned | Securities<br>Sold, net yet<br>purchased |
|--|---------------------|--|
| Marketable:                            |                     |  |
| Corporate stocks, options, and futures | \$ 12,461           | \$ 8,339                                 |
|  | 12,461              | 8,339                                    |
| Not readily marketable:                |                     |  |
| Limited partnerships                   | 9,588               | -  |
| Warrants                               | 2,429               | -  |
| Equities                               | 426                 | -  |
|  | 12,443              | -  |
|  | \$ 24,904           | \$ 8,339                                 |

FASB ASC Topic 820, *Fair Value Measurements and Disclosures*, defines fair value, establishes a framework for measuring fair value, and establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. 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. The fair value hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements).

**Sanders Morris Harris Inc. (formerly SMH Capital Inc.)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

December 31, 2009

**NOTE F – SECURITIES OWNED AND SECURITIES SOLD, NOT YET PURCHASED – Continued**

The three levels of the fair value hierarchy are as follows:

Level 1 - Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;

Level 2 - Quoted prices in markets that are not considered to be active or financial instruments for which all significant inputs are observable, either directly or indirectly;

Level 3 - Prices or valuations that require inputs that are both significant to the fair value measurement and unobservable.

A description of the valuation methodologies used for securities measured at fair value, as well as the general classification of such securities pursuant to the valuation hierarchy, is set forth below:

In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon industry-standard pricing methodologies, models, or other valuation methodologies that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that securities are recorded at fair value. The Company's valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values.

Level 1 consists of unrestricted publicly traded equity securities traded on an active market whose values are based on quoted market prices.

Level 2 includes securities that are valued using industry-standard pricing methodologies, models, or other valuation methodologies. Level 2 inputs are other than quoted market prices that are observable for the asset, either directly or indirectly. Level 2 inputs include quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; inputs other than quoted market prices that are observable for the asset, such as interest rates and yield curves observable at commonly quoted intervals, volatilities, credit risks, prepayment speeds, loss severities, and default rates; and inputs that are derived principally from observable market data by correlation or other means. Securities in this category include restricted publicly traded equity securities, publicly traded equity securities traded on an inactive market, publicly traded debt securities, warrants whose underlying stock is publicly traded on an active market, and options that are not publicly traded or whose pricing is uncertain.

Level 3 includes securities whose fair value is estimated based on industry-standard pricing methodologies and internally developed models utilizing significant inputs not based on, nor corroborated by, readily available market information. This category primarily consists of investments in limited partnerships and equity securities that are not publicly traded.

A financial instrument's level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement.

**Sanders Morris Harris Inc. (formerly SMH Capital Inc.)**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2009

**NOTE F – SECURITIES OWNED AND SECURITIES SOLD, NOT YET PURCHASED – Continued**

The following table sets forth by level within the fair value hierarchy securities owned and securities sold, not yet purchased as of December 31, 2009 (in thousands):

|                                       | <u>Level 1</u> | <u>Level 2</u> | <u>Level 3</u> | <u>Total</u> |
|---------------------------------------|----------------|----------------|----------------|--------------|
| Securities owned                      | \$ 11,815      | \$ 3,069       | \$ 8,820       | \$ 23,704    |
| Securities sold,<br>not yet purchased | 8,228          | 111            | -              | 8,339        |

The following table sets forth a summary of changes in the fair value of the Company's Level 3 securities owned for the year ended December 31, 2009 (in thousands):

|   | <u>Limited<br/>partnerships</u> | <u>Warrants</u> | <u>Equities</u> | <u>Total</u>    |
|---|---------------------------------|-----------------|-----------------|-----------------|
| Balance, beginning of year  | \$ 8,522                        | \$ 10           | \$ 684          | \$ 9,216        |
| Realized gains  | 20                              | -               | -               | 20              |
| Unrealized losses relating to<br>securities still held at<br>the reporting date | (29)                            | (5)             | (258)           | (292)           |
| Purchases, issuances and<br>settlements   | (124)                           | -               | -               | (124)           |
| Balance, end of year  | <u>\$ 8,389</u>                 | <u>\$ 5</u>     | <u>\$ 426</u>   | <u>\$ 8,820</u> |

Net unrealized losses for Level 3 securities owned are a component of "Principal transactions, net" and "Equity in loss of limited partnerships" in the Consolidated Statement of Operations as follows for the year ended December 31, 2009 (in thousands):

|   | <u>Principal<br/>transactions,<br/>net</u> | <u>Equity in<br/>loss<br/>of limited<br/>partnerships</u> |
|---|--|---|
| Unrealized losses relating to securities<br>still held at the report date | \$ (100)                                   | \$ (192)  |

At December 31, 2009, the Company had \$1.2 million in securities owned that are valued using the equity method, which approximates fair value.

**Sanders Morris Harris Inc. (formerly SMH Capital Inc.)**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

**NOTE F – SECURITIES OWNED AND SECURITIES SOLD, NOT YET PURCHASED – Continued**

The investments in limited partnerships are accounted for at fair value, and principally consist of ownership in the following private investment partnerships: Corporate Opportunities Fund, L.P.; Corporate Opportunities Fund (Institutional), L.P.; Sanders Opportunity Fund, L.P.; Sanders Opportunity Fund (Institutional), L.P.; Life Sciences Opportunity Fund, L.P.; Life Sciences Opportunity Fund (Institutional), L.P.; Life Sciences Opportunity Fund II, L.P.; Life Sciences Opportunity Fund (Institutional) II, L.P., SMH Private Equity Group I, L.P., SMH Private Equity Group II, L.P., and SMH NuPhysicia, LLC. The Company expects to receive its interests in the limited partnerships over the remaining one to ten year life of the limited partnerships. A summary of the combined results of operations and combined net assets of the limited partnerships is as follows as of and for the year ended December 31, 2009 (in thousands) (unaudited):

|   |                   |
|---|-------------------|
| Combined results of operations:                         |                   |
| Net investment loss                                     | \$ (2,471)        |
| Change in unrealized loss on investments                | 21,186            |
| Realized gain on investments                            | 2,842             |
| Increase in partners' capital resulting from operations | <u>\$ 21,557</u>  |
| Combined total assets                                   | \$ 213,343        |
| Combined total liabilities                              | 856               |
| Combined net assets                                     | <u>\$ 212,487</u> |

**NOTE G – FURNITURE, EQUIPMENT, AND LEASEHOLD IMPROVEMENTS, NET**

Furniture, equipment, and leasehold improvements, net, consist of the following at December 31, 2009 (in thousands):

|   |                 |
|---|-----------------|
| Furniture and fixtures                                | \$ 4,004        |
| Office equipment                                      | 6,969           |
| Leasehold improvements                                | 12,132          |
|   | 23,105          |
| Accumulated depreciation and amortization             | (13,383)        |
| Furniture, equipment, and leasehold improvements, net | <u>\$ 9,722</u> |

**Sanders Morris Harris Inc. (formerly SMH Capital Inc.)**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009

**NOTE H – INCOME TAXES (Restated)**

The income tax provision (benefit) was composed of the following for the year ended December 31, 2009 (in thousands):

|   |            |
|---|------------|
| From continuing operations:                   |            |
| Current                                       | \$ (6,683) |
| Deferred                                      | 3,480      |
| Income tax benefit from continuing operations | (3,203)    |
| From discontinued operations                  | (353)      |
| Income tax benefit                            | \$ (3,556) |

The difference between the effective tax rate reflected in the income tax provision (benefit) from continuing operations and the statutory federal rate for the year ended December 31, 2009 is analyzed as follows (in thousands):

|   |            |
|---|------------|
| Expected federal tax at statutory rate of 34% | \$ (2,853) |
| State taxes                                   | (419)      |
| Other   | 69         |
| Income tax benefit                            | \$ (3,203) |

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2009 are presented below (in thousands):

|  |            |
|--|------------|
| Deferred tax assets:   |            |
| Excess of tax over book basis in limited partnership investments | \$ 2,253   |
| Charitable contributions   | 18         |
| Compensation for unrealized gains                                | 350        |
| Allowance for bad debts  | 918        |
| Restricted stock compensation                                    | 337        |
| Total gross deferred tax assets                                  | 3,876      |
| Deferred tax liabilities:  |            |
| Unrealized gain on securities owned                              | (2,665)    |
| Excess of tax over book basis in fixed assets                    | (442)      |
| Prepaid expenses   | (134)      |
| Gain on sale of business   | (3,034)    |
| Total gross deferred tax liabilities                             | (6,275)    |
| Net deferred tax liability                                       | \$ (2,399) |

**Sanders Morris Harris Inc. (formerly SMH Capital Inc.)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

December 31, 2009

**NOTE H – INCOME TAXES (Restated) – Continued**

There was no valuation allowance for deferred tax assets as of December 31, 2009. In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not that the Company will generate sufficient taxable income to realize the benefits of these deductible differences at December 31, 2009.

**NOTE I – CONCENTRATIONS OF RISK**

In the normal course of business, the Company enters into securities sales transactions as principal. If the securities subject to such transactions are not in the possession of the Company, the Company is subject to risk of loss if it must acquire the security on the open market at a price that exceeds the contract amount of the transaction.

The Company executes, as agent, securities transactions on behalf of its customers. If either the customer or a counterparty fails to perform, the Company may be required to discharge the obligations of the nonperforming party. In such circumstances, the Company may sustain a loss if the market value of the security is different from the contract value of the transaction. The Company's customer security transactions are transacted on either a cash or margin basis. In margin transactions, the customer is extended credit by the clearing broker, subject to various regulatory margin requirements, collateralized by cash and securities in the customer's account. In connection with these activities, the Company executes customer transactions with the clearing broker involving the sale of securities not yet purchased (short sales). In the event the customer fails to satisfy its obligation, the Company may be required to purchase financial instruments at prevailing market prices in order to fulfill the customer's obligations.

The Company's policy is to monitor its market exposure, customer risk, and counterparty risk through the use of a variety of credit exposure reporting and control procedures, including marking-to-market securities, and any related collateral as well as requiring adjustments of collateral levels as necessary. In addition, the Company has a policy of reviewing, as considered necessary, the credit standing of each counterparty and customer with which it conducts business.

The Company is subject to credit risk to the extent that its deposits with commercial banks exceed the Federal Deposit Insurance Corporation insurable limit of \$250,000. Management does not consider this risk to be significant.

**Sanders Morris Harris Inc. (formerly SMH Capital Inc.)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

December 31, 2009

**NOTE J – COMMITMENTS AND CONTINGENCIES**

The Company leases office space under noncancelable operating leases that expire by 2018 with initial noncancelable terms in excess of one year. Rent expense on operating leases is recognized on a straight line basis over the life of the respective leases. Rental expense for the year ended December 31, 2009 totaled \$3.7 million. Future minimum rentals approximate (in thousands):

|                               |                  |
|-------------------------------|------------------|
| Year ending:                  |                  |
| 2010                          | \$ 7,997         |
| 2011                          | 7,837            |
| 2012                          | 6,949            |
| 2013                          | 5,451            |
| 2014                          | 2,250            |
| Thereafter                    | <u>4,551</u>     |
| Total minimum rental payments | 35,035           |
| Minimum sublease rentals      | <u>(6,736)</u>   |
| Net minimum rental payments   | <u>\$ 28,299</u> |

In the normal course of business, the Company enters into underwriting commitments. There were no firm underwriting commitments open at December 31, 2009.

The Company has uncommitted financing arrangements with clearing brokers that finance our customer accounts, certain broker-dealer balances, and firm trading positions. Although these customer accounts and broker-dealer balances are not reflected on the consolidated statement of financial condition for financial reporting purposes, the Company has generally agreed to indemnify these clearing brokers for losses they may sustain in connection with the accounts, and therefore, retains risk on these accounts. The Company is required to maintain certain cash or securities on deposit with our clearing brokers. Deposits with clearing organizations were \$2.5 million at December 31, 2009.

The Company has issued letters of credit in the amounts of \$420,000, \$245,000, \$230,000, and \$96,000 to the owners of four of the offices that we lease to secure payment of our lease obligation for that facility.

The Company is a defendant in certain litigation incidental to its securities and underwriting business. Management of the Company, after consultation with outside legal counsel, believes that the resolution of these lawsuits will not result in any material adverse effect on the Company's consolidated financial position, results of operations, or cash flows.

**NOTE K – RELATED-PARTY TRANSACTIONS**

The Company earned fees of \$768,000 through sales of annuity products from HWG Insurance Agency, Inc. ("HWG") during 2009. The sole shareholder of HWG was an employee of the Company. The Company purchased all of the shares of HWG during 2009 and is now the sole shareholder.



**Sanders Morris Harris Inc. (formerly SMH Capital Inc.)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

December 31, 2009

**NOTE K – RELATED-PARTY TRANSACTIONS – Continued**

In conjunction with their employment, certain employees and groups of independent brokers of the Company were granted restricted common shares of SMHG under the Incentive Plan. The value of the shares will be expensed by the Company over the one to five-year vesting period. In the event that employment or affiliation with the company is terminated, all unvested shares will be forfeited. During 2009, the value of SMHG common stock granted to Company employees aggregated \$84,000. The unamortized portions of the grants are reported in other assets and amount to \$2.0 million at December 31, 2009. Compensation expense related to forgiveness of notes receivable and to amortization expense of unearned compensation amounted to \$2.3 million in 2009.

Receivable from Parent, affiliates, and subsidiaries, net, for income taxes, expense reimbursements, issuance of SMHG common stock to Company employees, and other cash advances was \$5.8 million at December 31, 2009.

During 2001, the Company formed PTC – Houston Management, L.P. (“PTC”) to secure financing for a new proton beam therapy cancer treatment center to be constructed in Houston. A former advisory director of SMHG and his family are the principal owners of an entity that is a 50% owner of PTC. Net operating income recognized by PTC totaled \$2.3 million in 2009, of which \$974,000 was attributable to the Company and \$1.1 million was attributable to the advisory director-owned entity. The Company has granted a 7.5% ownership interest in PTC to an employee who serves as a manager of PTC.

**NOTE L – BENEFIT PLANS**

The Company’s employees participate in the SMHG 401(k) plan. There were no Company matching contributions during 2009.

**NOTE M – DEFERRED COMPENSATION PLANS**

As part of certain underwriting agreements with its customers, the Company is awarded warrants, options, or equities, which it contributes to a deferred compensation plan with key executives and employees. The Company is contractually obligated to pay all proceeds, if any, to these key executives and employees, from the exercise or sale of such securities. No such securities were owned at December 31, 2009, which correspond to deferred compensation liabilities under the plan.

**NOTE N – NET CAPITAL REQUIREMENTS**

The Company is subject to the Securities and Exchange Commission’s Uniform Net Capital Rule (SEC Rule 15c3-1), which requires the maintenance of minimum net capital and requires that the ratio of aggregate indebtedness to net capital, both as defined, shall not exceed 15 to 1. At December 31, 2009, the Company had net capital, as defined, of \$10.8 million, which was \$9.8 million in excess of the required minimum net capital of \$1.0 million. At December 31, 2009, the Company had aggregate indebtedness of \$14.8 million. The Company’s aggregate indebtedness to net capital ratio was 1.37 to 1 at December 31, 2009.

**Sanders Morris Harris Inc. (formerly SMH Capital Inc.)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

December 31, 2009

**NOTE O – SUBORDINATED LIABILITIES**

The Company had no subordinated liabilities during the year ended December 31, 2009. Therefore, the statement of changes in liabilities subordinated to claims of general creditors has not been presented.

**NOTE P – EXEMPTION FROM RULE 15c3-3**

The Company claims the exemptive provisions of SEC Rule 15c3-3 under paragraph (k)(2)(ii). Under this exemption, the “Computation for Determination of Reserve Requirements” and “Information Relating to the Possession or Control Requirements” are not required.

**NOTE Q – SUPPLEMENTAL CASH FLOW INFORMATION**

Supplemental disclosures of cash flow information:

|                                 |    |    |
|---------------------------------|----|----|
| Cash paid for interest          | \$ | 17 |
| Cash paid for income taxes, net |    | 3  |

Supplemental disclosures of noncash transactions:

|  |    |    |
|--|----|----|
| Deferred charge related to grants of common stock of Parent to employees and groups of independent brokers | \$ | 84 |
|--|----|----|

Non-cash investing activities:

Dispositions:

|   |    |         |
|---|----|---------|
| Receivables, net                                      | \$ | 7,850   |
| Securities owned                                      |    | 1,200   |
| Furniture, equipment, and leasehold improvements, net |    | (2,729) |
| Other assets  |    | (469)   |
| Accounts payable and accrued liabilities              |    | 2,440   |

**NOTE R – DISCONTINUED OPERATIONS (Restated)**

During the first quarter of 2009, the Company closed three retail offices. This decision was made due to the offices' inability to achieve sufficient revenue to offset their costs. The results of operations for these offices have been reclassified as discontinued operations for the year ended December 31, 2009.

During the fourth quarter of 2009, the Company contributed to Madison Williams the Capital Markets Business in exchange for a 17.5% Class A membership interest in Madison Williams, cash, and a note issued by Madison Williams to the Company. The results of operations for the Capital Markets Business have been reclassified as discontinued operations for the year ended December 31, 2009.

**Sanders Morris Harris Inc. (formerly SMH Capital Inc.)**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2009

**NOTE R – DISCONTINUED OPERATIONS (Restated) – Continued**

A summary of selected financial information of discontinued operations is as follows for the year ended December 31, 2009 (in thousands):

|  |                        |
|--|------------------------|
| Operating activities:  |                        |
| Revenue  | \$ 25,191              |
| Expenses   | <u>34,388</u>          |
| Loss from discontinued operations before income taxes        | (9,197)                |
| Benefit from income taxes                                    | <u>(3,587)</u>         |
| Loss from operations of discontinued operations              | (5,610)                |
| Gain on sale of discontinued operations, net of income taxes | <u>5,059</u>           |
| Loss from discontinued operations                            | <u><u>\$ (551)</u></u> |

Major classes of assets and liabilities of the closed offices and the Capital Markets Business accounted for as discontinued operations in the accompanying Consolidated Statement of Financial Condition at December 31, 2009 were as follows (in thousands):

|  |                      |
|--|----------------------|
| Furniture, fixtures, and office equipment, net | <u>\$ 179</u>        |
| Total assets of discontinued operations        | <u><u>\$ 179</u></u> |
| Accounts payable and accrued liabilities       | <u>\$ 89</u>         |
| Total liabilities of discontinued operations   | <u><u>\$ 89</u></u>  |



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The Board of Directors  
Sanders Morris Harris Inc. (formerly SMH Capital Inc.)

In planning and performing our audit of the consolidated financial statements and supplemental schedule of Sanders Morris Harris Inc. (the "Company") and subsidiaries as of and for the year ended December 31, 2009, in accordance with auditing standards generally accepted in the United States of America, we considered the Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

Also, as required by Rule 17a-5(g)(1) of the Securities and Exchange Commission ("SEC"), we have made a study of the practices and procedures followed by the Company including consideration of control activities for safeguarding securities. This study included tests of such practices and procedures that we considered relevant to the objectives stated in Rule 17a-5(g) in making the periodic computations of aggregate indebtedness (or aggregate debits) and net capital under Rule 17a-3(a) (11) and for determining compliance with the exemptive provisions of Rule 15c3-3. Because the Company does not carry securities accounts for customers or perform custodial functions relating to customer securities, we did not review the practices and procedures followed by the Company in any of the following:

1. Making quarterly securities examinations, counts, verifications, and comparisons and recordation of differences required by Rule 17a-13.
2. Complying with the requirements for prompt payment for securities under Section 8 of Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System.

The management of the Company is responsible for establishing and maintaining internal control and the practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls and of the practices and procedures referred to in the preceding paragraph and to assess whether those practices and procedures can be expected to achieve the SEC's above-mentioned objectives. Two of the objectives of internal control and the practices and procedures are to provide management with reasonable, but not absolute assurance that assets for which the Company has responsibility are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with

The Board of Directors  
Sanders Morris Harris Inc. (formerly SMH Capital Inc.)  
Page 2

management's authorization and recorded properly to permit the preparation of financial statements in conformity with generally accepted accounting principles. Rule 17a-5(g) lists additional objectives of the practices and procedures listed in the preceding paragraph.

Because of inherent limitations in internal control and the practices and procedures referred to above, errors or fraud may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company's financial statements will not be prevented or detected on a timely basis.

Our consideration of internal control was for the limited purpose described in the first and second paragraphs and would not necessarily identify all deficiencies in internal control that might be material weaknesses. However, we identified the following deficiencies in internal control that we consider to be material weaknesses, as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures performed in our audit of the consolidated financial statements of Sanders Morris Harris Inc. as of and for the year ended December 31, 2009, and this report does not affect our report thereon dated February 26, 2010, except for the specified notes for which the date is March 23, 2010. The Company's technical review of non-recurring transactions did not occur on a timely basis. Therefore, when the Company disposed of the Capital Markets Business, the Company did not adequately research the accounting guidance related to this transaction specifically related to the classification of the gain on the sale, until after the consolidated financial statements had been issued and filed. As a result of this deficiency, the Company restated its previously filed consolidated financial statements for the period ended December 31, 2009.

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are considered by the SEC to be adequate for its purposes in accordance with the Securities Exchange Act of 1934 and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Company's practices and procedures, as described in the second paragraph of this report, were adequate at December 31, 2009 to meet the SEC's objectives.

The Board of Directors  
Sanders Morris Harris Inc. (formerly SMH Capital Inc.)  
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This report is intended solely for the information and use of the board of directors, management, the SEC, the National Association of Securities Dealers, Inc. and other regulatory agencies that rely on Rule 17a-5 (g) under the Securities and Exchange Act of 1934 in their regulation of registered brokers and dealers, and is not intended to be and should not be used by anyone other than these specified parties.

*Grant Thornton LLP*

Houston, Texas  
March 23, 2010

**Sanders Morris Harris Inc. (formerly SMH Capital Inc.)**

**COMPUTATION OF NET CAPITAL UNDER RULE 15c3-1  
OF THE SECURITIES AND EXCHANGE COMMISSION**

December 31, 2009  
(Dollars in thousands)

|   |             |                           |
|---|-------------|---------------------------|
| Net capital:  |             |                           |
| Total consolidated stockholder's equity attributable to Sanders Morris Harris Inc.<br>per the accompanying financial statements                                     | \$          | 56,639                    |
| Other allowable credits   |             | 8,531                     |
|   |             | 65,170                    |
| Nonallowable assets:  |             |                           |
| Nonallowable receivables  |             | (15,076)                  |
| Furniture, equipment, and leasehold improvements, net   |             | (9,722)                   |
| Not readily marketable securities   |             | (12,443)                  |
| Receivable from Parent, affiliates, and subsidiaries  |             | (6,645)                   |
| Other nonallowable assets   |             | (7,281)                   |
| Total nonallowable assets   |             | (51,167)                  |
| Net capital before haircuts on securities positions   |             | 14,003                    |
| Haircuts on securities positions  |             | (3,238)                   |
| Net capital   | \$          | 10,765                    |
| Aggregate indebtedness:   |             |                           |
| Payable to broker-dealers   | \$          | 23                        |
| Accounts payable and other accrued liabilities  |             | 10,696                    |
| Sales commissions and bonuses payable   |             | 4,078                     |
| Total aggregate indebtedness  | \$          | 14,797                    |
| Ratio of aggregate indebtedness to net capital  |             | 1.37                      |
| Computation of basic net capital requirement:   |             |                           |
| Minimum net capital required (greater of 6-2/3% of<br>aggregate indebtedness or \$250)  | \$          | 986                       |
| Excess net capital  | \$          | 9,779                     |
| Note:   |             |                           |
| Computed regulatory net capital and aggregate indebtedness differ<br>from that disclosed in the FOCUS report filed under<br>X-17A-5 on January 26, 2010 as follows: |             |                           |
|   | Net capital | Aggregate<br>indebtedness |
| Per FOCUS report  | \$ 13,207   | \$ 12,390                 |
| Post-closing adjustments, net   | (2,442)     | 2,407                     |
| Per above   | \$ 10,765   | \$ 14,797                 |

See accompanying report of public registered public accounting firm.

