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# ANNUAL AUDITED REPORT FORM X-17A-5 PART III

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 1/1/06 AND ENDING 12/31/06  
MM/DD/YY MM/DD/YY

## A. REGISTRANT IDENTIFICATION

NAME OF BROKER-DEALER:

Lyster Watson Securities, Inc.

OFFICIAL USE ONLY
FIRM ID. NO.

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

888 Seventh Avenue, 40th Floor

(No. and Street)

New York

NY

10019

(City)

(State)

(Zip Code)

NAME AND TELEPHONE NUMBER OF PERSON TO CONTACT IN REGARD TO THIS REPORT

Liza Kahn - Garber

212-841-6804

(Area Code -- Telephone No.)

## B. ACCOUNTANT IDENTIFICATION

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

J.H. Cohn LLP

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

1212 Avenue of the Americas

New York

NY

10036

(Address)

(City)

(State)

(Zip Code)

CHECK ONE:

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

PROCESSED

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\*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).

SEC 1410 (06-02)

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OATH OR AFFIRMATION

I, Robert C. Watson, swear (or affirm) that, to the best of my knowledge and belief the accompanying financial statement and supporting schedules pertaining to the firm of Lyster Watson Securities, Inc., as of December 31, 2006, 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:

\_\_\_\_\_  
\_\_\_\_\_

LINDSAY PINZINO  
Notary Public, State of New York  
No. 01P16055858  
Qualified in Nassau County  
Commission Expires March 12, 2007

  
\_\_\_\_\_  
Signature

President  
\_\_\_\_\_  
Title

  
\_\_\_\_\_  
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 Cash Flows.
- (e) Statement of Changes in Stockholders' Equity or Partners' or Sole Proprietor's 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.
- (o) Independent auditor's report on internal accounting control.
- (p) Schedule of segregation requirements and funds in segregation--customers' regulated commodity futures account pursuant to Rule 171-5.

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

LYSTER WATSON SECURITIES, INC.

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**Lyster Watson Securities, Inc.**

**Report on Financial Statements  
(With Supplementary Information)**

**Year Ended December 31, 2006**

**Report of Independent Public Accountants**

To the Board of Directors  
Lyster Watson Securities, Inc.

We have audited the accompanying statement of financial condition of Lyster Watson Securities, Inc. as of December 31, 2006, and the related statements of operations, changes in stockholders' 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 financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. 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 examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 financial statements referred to above present fairly, in all material respects, the financial position of Lyster Watson Securities, Inc. as of December 31, 2006, and its results of operations and cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information contained in Schedule I is presented for purposes of additional analysis and is not a required part of the basic 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 financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.



New York, New York  
February 21, 2007

**LYSTER WATSON SECURITIES, INC.**  
**STATEMENT OF FINANCIAL CONDITION**  
**DECEMBER 31, 2006**

**ASSETS**

Cash and cash equivalents	\$183,137
Prepaid expenses	8,103
Referral fees receivable	<u>55,400</u>
Total	<u>\$246,640</u>

**LIABILITIES AND STOCKHOLDERS' EQUITY**

Liabilities - accrued expenses	<u>\$ 17,422</u>
Contingencies	
Stockholders' equity:	
Common stock, par value \$.01 per share; 200 shares authorized, issued and outstanding	2
Additional paid-in capital	261,287
Accumulated deficit	<u>(32,071)</u>
Total stockholders' equity	<u>229,218</u>
Total	<u>\$246,640</u>

See Notes to Financial Statements.

LYSTER WATSON SECURITIES, INC.

STATEMENT OF OPERATIONS  
YEAR ENDED DECEMBER 31, 2006

Revenues:	
Referral fees	\$841,024
Dividend and interest income	<u>4,039</u>
Total	<u>845,063</u>
Expenses:	
Regulatory fees	12,830
General and administrative	56,880
Management and administrative services fee	<u>672,862</u>
Total	<u>742,572</u>
Net income	<u>\$102,491</u>

See Notes to Financial Statements.

LYSTER WATSON SECURITIES, INC.

STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY  
YEAR ENDED DECEMBER 31, 2006

	<u>Common Stock</u>		<u>Additional</u>	<u>Accumulated</u>	<u>Total</u>
	<u>Shares</u>	<u>Amount</u>	<u>Paid-in</u>	<u>Deficit</u>	<u>Stockholders'</u>
			<u>Capital</u>		<u>Equity</u>
Balance, beginning of year	200	\$2	\$218,283	\$(134,562)	\$ 83,723
Capital contributions			43,004		43,004
Net income	—	—	—	102,491	102,491
Balance, end of year	<u>200</u>	<u>\$2</u>	<u>\$261,287</u>	<u>\$ (32,071)</u>	<u>\$229,218</u>

See Notes to Financial Statements.

LYSTER WATSON SECURITIES, INC.

STATEMENT OF CASH FLOWS  
YEAR ENDED DECEMBER 31, 2006

Operating activities:	
Net income	\$102,491
Adjustments to reconcile net income to net cash provided by operating activities:	
Changes in operating assets and liabilities:	
Prepaid expenses	(4,030)
Referral fees receivable	(55,400)
Accrued expenses	<u>6,180</u>
Net cash provided by operating activities	<u>49,241</u>
Financing activities - capital contributions	<u>43,004</u>
Net increase in cash and cash equivalents	92,245
Cash and cash equivalents, beginning of year	<u>90,892</u>
Cash and cash equivalents, end of year	<u>\$183,137</u>

See Notes to Financial Statements.

# LYSTER WATSON SECURITIES, INC.

## NOTES TO FINANCIAL STATEMENTS

### Note 1 - Organization and summary of significant accounting policies:

#### **Organization:**

Lyster Watson Securities, Inc. (the "Company") was incorporated in Delaware on January 22, 1992. The Company is a broker-dealer registered with the Securities and Exchange Commission (the "SEC") and is a member of the National Association of Securities Dealers, Inc. The Company operates under the exemptive provisions of SEC Rule 15c3-3k(2)(i). During 2006, the Company terminated its agreement with its clearing broker.

The Company derives its revenues primarily from referral fees from hedge fund managers.

The accompanying financial statements have been prepared from the separate records maintained by the Company and, due to certain transactions and agreements with affiliated entities, such financial statements may not necessarily be indicative of the financial condition that would have existed or the results that would have been obtained from operations had the Company operated as an unaffiliated entity.

#### **Use of estimates:**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

#### **Referral fees:**

The Company derives referral fee revenues from the introduction of accredited investors or qualified purchasers to hedge fund managers unaffiliated with the Company or any of its affiliates. The Company has agreements with various hedge fund managers to receive a portion of the hedge fund manager's management and/or performance fees based on assets the Company has placed with the hedge fund manager. These fees are recorded on the accrual basis when earned.

#### **Cash equivalents:**

Investments in money market funds are classified as cash equivalents.

#### **Concentration risks:**

##### **Cash:**

Financial instruments which potentially subject the Company to concentrations of credit risk consist primarily of cash and cash equivalents. The Company's cash and cash equivalent balances may at times exceed Federally insured limits.

**LYSTER WATSON SECURITIES, INC.**

**NOTES TO FINANCIAL STATEMENTS**

**Note 1 - Organization and summary of significant accounting policies (concluded):**

**Concentration risks (concluded):**

**Major customers:**

During 2006, the Company earned 99% of its revenue from one hedge fund manager. Substantially all of the referral fees receivable at December 31, 2006 are due from this same hedge fund manager.

**Income taxes:**

The Company, with the consent of its stockholders, has elected to be treated as an "S" Corporation under certain sections of the Internal Revenue Code and Section 660 Article 22 of New York State Tax Law. Under these sections, corporate income, in general, is taxable to the stockholders in proportion to their respective interests. The City of New York does not recognize "S" Corporations for income tax reporting purposes.

The Company accounts for city income taxes pursuant to the asset and liability method which requires deferred income tax assets and liabilities to be computed for temporary differences between the financial statement and tax bases of assets and liabilities that will result in taxable or deductible amounts in the future based on enacted tax laws and rates applicable to the periods in which the temporary 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.

**Note 2 - Related party transactions:**

Lyster Watson Management, Inc. (the "Affiliate") provides the Company with certain management and administrative services. Expenses include management and administrative fees charged for these services of \$672,862.

**Note 3 - Net capital requirement:**

The Company is subject to the SEC Uniform Net Capital Rule (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. Rule 15c3-1 also provides that equity capital may not be withdrawn or cash distributions paid if the resulting net capital ratio would exceed 10 to 1. At December 31, 2006, the Company had net capital of \$154,697, which was \$149,697 in excess of its required net capital of \$5,000. The Company's net capital ratio was .11 to 1.

LYSTER WATSON SECURITIES, INC.

NOTES TO FINANCIAL STATEMENTS

**Note 4 - Income taxes:**

At December 31, 2006, the Company has available city net operating loss carryforwards of approximately \$27,000 expiring through 2025. Deferred tax assets related to such carryforwards are immaterial. There is no current income tax expense in 2006 due to the tax benefit of \$9,100 from the utilization of net operating loss carryforwards. As a result of the decrease in the valuation allowance of \$9,100 during 2006, there is also no deferred income tax expense reflected in the accompanying statement of operations.

**Note 5 - Contingency:**

The Affiliate has an installment loan payable to a bank which, at December 31, 2006, has a balance of \$583,333. The loan, which bears interest at 6%, is payable in monthly installments of \$16,667 plus interest through November 2009. The loan is secured by all of the assets of the Affiliate, Lyster Watson LLC and the Company and is guaranteed by the stockholders of the Company. As of December 31, 2006, the Affiliate is current with its debt payments.

LYSTER WATSON SECURITIES, INC.

SCHEDULE I - COMPUTATION OF NET CAPITAL UNDER  
RULE 15c3-1 OF THE SECURITIES AND EXCHANGE COMMISSION  
DECEMBER 31, 2006

Total stockholders' equity	<u>\$229,218</u>
Deduct nonallowable assets:	
Referral fees receivable	55,400
Prepaid expenses	<u>8,103</u>
Total nonallowable assets	<u>63,503</u>
Net capital before haircuts on securities positions	165,715
Haircuts on securities positions - money market instruments	<u>(11,018)</u>
Net capital	<u>\$154,697</u>
Aggregate indebtedness	<u>\$ 17,422</u>
Computation of basic net capital requirement:	
Minimum net capital required (greater of 6-2/3% of aggregate indebtedness or \$5,000 minimum dollar net capital requirement)	<u>\$ 5,000</u>
Excess of net capital over minimum net capital	<u>\$149,697</u>
Excess of net capital at 1,000%	<u>\$152,954</u>
Ratio of aggregate indebtedness to net capital	<u>.11 to 1</u>

No material discrepancies exist between the above computation and the computation included in the Company's corresponding unaudited Form X-17A-5 Part IIA filing.

See Report of Independent Public Accountants.

## **Report of Independent Public Accountants on Internal Control**

To the Board of Directors  
Lyster Watson Securities, Inc.

In planning and performing our audit of the financial statements of Lyster Watson Securities, Inc. (the "Company") as of and for the year ended December 31, 2006, 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 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 (the "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 management's authorization and recorded properly to permit the preparation of financial statements in conformity with accounting principles generally accepted in the United States of America. 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, error 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 adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with accounting principles generally accepted in the United States of America such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

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. We did not identify any deficiencies in internal control and control activities for safeguarding securities that we consider to be material weaknesses, as defined above.

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, 2006 to meet the SEC's objectives.

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 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.

*J. H. Cohn LLP*

New York, New York  
February 21, 2007

*END*