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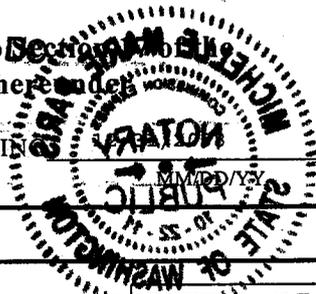
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ANNUAL AUDITED REPORT  
FORM X-17A-5 Section  
PART III  
FEB 27 2009

SEC FILE NUMBER  
8- 39227

FACING PAGE  
Information Required of Brokers and Dealers Pursuant to Section 17  
Securities Exchange Act of 1934 and Rule 17c-1 Thereunder



REPORT FOR THE PERIOD BEGINNING 1/1/2008 AND ENDING MM/DD/YY

A. REGISTRANT IDENTIFICATION

NAME OF BROKER-DEALER: Russell Financial Services, Inc.  
ADDRESS OF PRINCIPAL PLACE OF BUSINESS: (Do not use P.O. Box No.)  
909 A Street

OFFICIAL USE ONLY  
FIRM I.D. NO.

(No. and Street)  
Tacoma WA 98402  
(City) (State) (Zip Code)

NAME AND TELEPHONE NUMBER OF PERSON TO CONTACT IN REGARD TO THIS REPORT  
Damon B. Joyner 253 439-4311  
(Area Code - Telephone Number)

B. ACCOUNTANT IDENTIFICATION

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

PricewaterhouseCoopers LLP

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

1420 Fifth Avenue, Suite 1900 Seattle WA 98101  
(Address) (City) (State) (Zip Code)

CHECK ONE:

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

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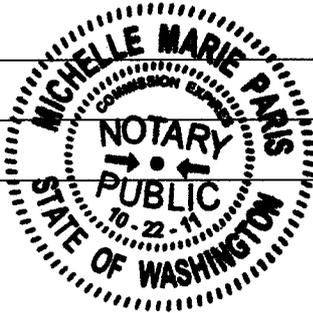
\*Claims for exemption from the requirement that the annual report be covered by the opinion of an independent public accountant must be supported by a statement of facts and circumstances relied on as the basis for the exemption. See Section 240.17a-5(e)(2)

AB  
3/16

OATH OR AFFIRMATION

I, Damon B. Joyner, swear (or affirm) that, to the best of my knowledge and belief the accompanying financial statement and supporting schedules pertaining to the firm of Russell Financial Services, Inc., as of December 31, 2008, 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:

N/A



Damon B. Joyner  
Signature

Controller, Treasurer, FinOp  
Title

Michelle Marie Paris  
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).

**Russell Financial Services, Inc.**  
**Index**  
**December 31, 2008**

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PricewaterhouseCoopers LLP  
1420 Fifth Avenue  
Suite 1900  
Seattle, WA 98101  
Telephone (206) 398 3000  
Facsimile (206) 398 3100

**Report of Independent Auditors**

To the Board of Directors and Stockholder of  
Russell Financial Services, Inc.

In our opinion, the accompanying statement of financial condition presents fairly, in all material respects, the financial position of Russell Financial Services, Inc. (the "Company") at December 31, 2008, in conformity with accounting principles generally accepted in the United States of America. This financial statement is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement based on our audit. We conducted our audit of this statement in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the statement of financial condition is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the statement of financial condition, assessing the accounting principles used and significant estimates made by management, and evaluating the overall statement of financial condition presentation. We believe that our audit of the statement of financial condition provides a reasonable basis for our opinion.



Seattle, Washington  
February 26, 2009

**Russell Financial Services, Inc.**  
**Statement of Financial Condition**  
**As of December 31, 2008**

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**Assets**

Cash and cash equivalents	\$ 66,351,986
Distribution fees receivable	4,189,931
Prepaid expenses and other	881,826
Due from affiliates	1,130,874
Deferred income taxes, net	567,086
Fixed assets, net	<u>1,317,105</u>
Total assets	<u>\$ 74,438,808</u>

**Liabilities and Stockholder's Equity**

Liabilities

Distribution fees payable	\$ 13,102,068
Administrative fees payable	4,141,792
Compensation payable	3,833,436
Due to affiliates	9,912,876
Accrued expenses and other liabilities	1,600,414
Incentive compensation liabilities	<u>219,314</u>
Total liabilities	<u>32,809,900</u>

Commitments, contingencies, and guarantees (Notes 8, 10 and 11)

Stockholder's equity

Common stock, par value \$0.10 per share; 100 shares authorized; 26 shares issued and outstanding	3
Additional paid-in capital	44,719,235
Accumulated deficit	<u>(3,090,330)</u>
Total stockholder's equity	<u>41,628,908</u>
Total liabilities and stockholder's equity	<u>\$ 74,438,808</u>

The accompanying notes are an integral part of this financial statement.

**Russell Financial Services, Inc.**  
**Notes to Financial Statement**  
**December 31, 2008**

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**1. Nature of Business and Summary of Significant Accounting Policies**

**Nature of Business**

Russell Financial Services, Inc. (the "Company") (formerly Russell Fund Distributors, Inc.) is a wholly owned subsidiary of Russell Investment Management Company ("RIMCo") ("Parent"), a wholly owned subsidiary of Frank Russell Company ("Russell"), all of which are part of Russell Investments, the marketing name used to represent Russell and its global subsidiaries. The Northwestern Mutual Life Insurance Company owns substantially all of the outstanding shares of Russell.

The Company, a broker-dealer registered pursuant to the Securities Exchange Act of 1934, is a member of the Financial Industry Regulatory Authority ("FINRA"). The Company engages in the sale of redeemable shares of registered investment companies and direct participation programs in the United States of America and provides sales and client support services for Russell's institutional investor products and services. These products include alternative investment funds, registered mutual funds, commingled employee benefit funds, and implementation services.

Effective January 1, 2008, as part of a Russell reorganization effort, certain broker-dealer activities in another Russell broker-dealer entity transferred to the Company. This included the transfer of certain employees, assets, liabilities and all broker-dealer activities performed by the other entity. As the Company and the other Russell broker-dealer entity were entities under common control, the transfer was accounted for as a pooling of interests. As such, the January 1, 2008 stockholder's equity balances in the statement of changes in stockholder's equity reflect the pooling of the two entities. Additionally, as part of the reorganization effort, certain employees, assets and liabilities of RIMCo were transferred to the Company.

Russell Investment Company ("RIC") and Russell Investment Funds ("RIF") are registered investment companies affiliated with the Parent and Russell. The Company has entered into a distribution agreement with RIC and RIF. The Company has also entered into a sales support agreement and a shareholder servicing agreement with RIC.

**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 the reported amounts of assets and liabilities and disclosure of contingent liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates are inherent in the preparation of the financial statements. Actual results could differ materially from those estimates.

**Cash and Cash Equivalents**

The Company considers all money market funds and instruments with original maturities of three months or less at the purchase date as cash equivalents. Cash is held at financial institutions in excess of Federal Deposit Insurance Corporation ("FDIC") limits.

**Russell Financial Services, Inc.**  
**Notes to Financial Statement**  
**December 31, 2008**

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**Fixed Assets**

Fixed assets are reported at cost less accumulated depreciation and amortization. Depreciation is calculated using the straight-line method based on estimated useful lives ranging from three to seven years. Furniture and equipment are depreciated over estimated useful lives ranging from three to seven years. Capitalized software includes purchased and internally developed software. Purchased software is amortized over three years using the straight-line method. Internally developed software represents internal and external costs incurred to develop internal use software during the application development stage. Once the internal use software is ready for its intended use, the accumulated development costs are amortized over three years using the straight-line method. Leasehold improvements are amortized over the shorter of their estimated useful lives or the remaining life of the lease. Depreciation of those assets recorded under capital lease agreements is included in depreciation expense. When fixed assets are sold or otherwise disposed of, the cost and related accumulated depreciation are removed from the respective accounts and the resulting gains or losses are included in income from operations. Repair and maintenance costs are expensed as incurred.

**Income Taxes**

The Company accounts for income taxes pursuant to Statement of Financial Accounting Standard ("SFAS") No. 109, *Accounting for Income Taxes*, which requires the recognition of deferred tax assets and liabilities for the expected future consequences of temporary differences between the carrying amounts and the tax bases of assets and liabilities. The Company records interest and penalties on amounts due to tax authorities as a component of income tax expense in its statement of income.

The Company files its federal tax return with Northwestern Mutual Life Insurance Company as part of a consolidated group. The provision for federal income taxes is based on an allocation of the consolidated tax liability to the respective companies included in the consolidated group as if each company were filing on a separate return basis. Federal taxes payable are recorded through and included in due to affiliates in the accompanying statement of financial condition. The Company files a separate tax return in certain states. State income taxes payable are included in accrued expenses in the accompanying statement of financial condition.

**Fair Values of Financial Instruments**

In September 2006, the Financial Accounting Standards Boards ("FASB") issued SFAS No. 157, *Fair Value Measurements* ("SFAS 157"). This statement defines fair value, establishes a hierarchal disclosure framework, and expands disclosures about fair value measurements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company adopted SFAS 157 beginning January 1, 2008.

In February 2008, the FASB issued FASB Staff Position No. 157-2, *Effective Date of FASB Statement No. 157* ("FSP 157-2"). FSP 157-2 permits a one-year deferral in applying the measurement provisions of SFAS 157 to nonfinancial assets and nonfinancial liabilities that are not recognized or disclosed at fair value in an entity's financial statements on a recurring basis (at least annually). The Company will adopt FSP 157-2 on January 1, 2009. The Company is currently assessing the potential impact FSP 157-2 will have on its financial statements.

The fair value disclosure framework prioritizes and ranks the level of market price observability used in measuring assets and liabilities at fair value into three broad levels. In some instances, the inputs used to measure fair value might fall in different levels of the fair value hierarchy. Inputs are used in applying the various valuation techniques and broadly refer to the assumptions that market participants use to make valuation decisions, including assumptions

**Russell Financial Services, Inc.**  
**Notes to Financial Statement**  
**December 31, 2008**

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about risk. Inputs may include price information, volatility statistics, specific and broad credit data, liquidity statistics, and other factors. The level in the fair value hierarchy within which the fair value measurement in its entirety falls shall be determined based on the lowest level input that is significant to the fair value measurement in its entirety. Assessing the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the asset or liability. The categorization of an investment within the hierarchy is based upon the pricing transparency of the investment and does not necessarily correspond to the Company's perceived risk of that investment.

**Stock-Based Compensation**

In December 2004, the FASB issued SFAS No. 123R, *Share-Based Payment* ("SFAS 123R"), which revises SFAS No. 123, *Accounting for Stock-based Compensation*, and supersedes APB 25, *Accounting for Stock Issued to Employees* ("APB 25"). SFAS 123R eliminates the alternative of using the intrinsic value method of accounting for share-based awards that was provided under APB 25. Effective January 1, 2006, the Company adopted SFAS 123R using the prospective transition method, which requires that only awards granted, modified, repurchased or canceled after the adoption date be subject to the standard. Under SFAS 123R, equity-classified awards are measured at fair value as of the grant dates or modification dates and the resulting cost is recognized in the statement of income over the period from the date of grant to the date when the award is no longer contingent upon the employee providing additional service (the required service period). For awards that vest upon retirement, the required service period does not extend beyond the date an employee is eligible for retirement. This situation can result in compensation expense being recognized over a period less than the stated vesting period.

In February 2007, Russell implemented the 2006 Long-term Equity-Based Incentive Plan (the "LTIP") and the Outstanding Contributor Award Program (the "OCAP"), as more fully described in Note 5, which are subject to the guidance of SFAS 123R.

**Deferred Incentive Compensation**

Russell has granted award units under the Incentive Share Plan ("ISP"), more fully described in Note 5. The Company accounts for these deferred incentive arrangements, which are not share-based, in accordance with the guidance in Accounting Principles Standards Board Omnibus Opinion No. 12, *Deferred Compensation Contracts*, using an accelerated method of attribution of the related expense.

**Revenue Recognition**

Revenue from distribution and shareholder servicing activities is recognized as earned in accordance with the terms of the respective agreements. Accounts are deemed past due based on payment terms. The Company writes off delinquent accounts to the extent and at the time they are deemed to not be recoverable. The Company recorded no bad debt expense for the year ended December 31, 2008.

Sales commissions received in connection with front-end load shares are recorded as revenue. For individual sales transactions exceeding a certain threshold, the Company is obligated to pay these sales commissions on behalf of the investor. These payments are recorded as an expense. If the investor redeems such shares before the expiration of a one year holding period, they are obligated to pay a deferred sales charge of 1%.

**Russell Financial Services, Inc.**  
**Notes to Financial Statement**  
**December 31, 2008**

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**New Accounting Pronouncements**

In June 2006, FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement 109* (“FIN 48”) was issued. FIN 48 requires that an entity disclose an assessment in its financial statements of the probable outcomes of tax positions deemed under the FIN to be “uncertain” as if such positions were subject to examination and to disclose the estimated effect of any changes in valuation of tax assets and liabilities anticipated as a result of such examination. The tax benefit to be recognized is measured as the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. FIN 48 must be applied to all existing tax positions upon initial adoption. The cumulative effect of applying FIN 48 at adoption, if any, is to be reported as an adjustment to opening retained earnings for the year of adoption. On December 30, 2008, the FASB issued FSP FIN 48-3, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*, which defers the effective date of FIN 48 for certain nonpublic entities. As a result of FSP FIN 48-3, in the absence of early adoption, FIN 48 will go into effect for certain nonpublic companies, including the Company, for annual periods beginning after December 15, 2008. The Company has elected to defer the initial adoption of FIN 48 and is currently assessing the potential impact that FIN 48 will have on its financial statements. The Company will continue to accrue for liabilities related to uncertain tax positions only when such liabilities are probable and reasonably estimable.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an Amendment of FASB Statement No. 115* (“SFAS 159”). SFAS 159 permits all entities the option to measure many financial instruments and certain other items at fair value. If a company elects the fair value option for an eligible item, then it will report unrealized gains and losses on those items at each subsequent reporting date. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The adoption of SFAS 159 did not have any impact on the Company’s financial statements.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* (“SFAS 141(R)”) which replaces SFAS No. 141, *Business Combinations*. SFAS 141(R) retains the underlying concepts of SFAS 141 in that all business combinations are still required to be accounted for at fair value under the acquisition method of accounting, however SFAS 141(R) changed the application of the acquisition method in a number of significant aspects. SFAS 141(R) is effective on a prospective basis for all business combinations for which the acquisition date is on or after the beginning of the first annual period subsequent to December 15, 2008, with the exception of the accounting for valuation allowances on deferred taxes and acquired tax contingencies. SFAS 141(R) amends SFAS 109 such that adjustments made to valuation allowances on deferred taxes and acquired tax contingencies associated with acquisitions that closed prior to the effective date of SFAS 141(R) would also apply the provisions of SFAS 141(R). Early adoption is not allowed. The Company plans to adopt SFAS 141(R) for all business combinations beginning in 2009.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interest in Consolidated Financial Statements – an amendment of ARB No. 51* (“SFAS 160”). SFAS 160 requires reporting entities to present noncontrolling (minority) interests as equity (as opposed to as a liability or mezzanine equity) and provides guidance on the accounting for transactions between an entity and non-controlling interest. SFAS 160 applies prospectively as of January 1, 2009, except for the presentation and disclosure requirements which will be applied retrospectively for all periods presented. The adoption of SFAS 160 will not have a material impact on the Company’s financial statements.

**Russell Financial Services, Inc.**  
**Notes to Financial Statement**  
**December 31, 2008**

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In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133* (“SFAS 161”). SFAS 161 is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity’s financial position, financial performance, and cash flows. SFAS 161 is effective for financial statements issued for fiscal years beginning after November 15, 2008, with early application encouraged. The adoption of SFAS 161 will not have a material impact on the Company’s financial statements.

**2. Fixed Assets**

Fixed assets consist of the following balances at December 31, 2008:

Software	\$ 1,125,603
Furniture and equipment	1,077,769
Leasehold improvements	490,039
	<u>2,693,411</u>
Accumulated depreciation and amortization	(1,657,229)
Work in progress	280,923
	<u>\$ 1,317,105</u>

**3. Asset and Liabilities Measured at Fair Value on a Recurring Basis**

Pursuant to SFAS 157, the Company carries at fair value on a recurring basis in the statement of financial condition certain investments of money market mutual funds.

The Company measures the fair value of its money market mutual funds using a market approach whereby it uses quoted market prices from the principal exchange on which each security trades.

Assets and liabilities measured and reported at fair value are classified and disclosed in one of the following categories based on the lowest level of input that is significant to the fair value measurement in its entirety:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access at the measurement date. Investments included in this category include the money market mutual funds.
- Level 2 inputs are inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly or indirectly as of the reporting date, and fair value is determined through the use of models or other valuation methodologies.
- Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs shall be used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. The inputs into the determination of fair value require significant management judgment or estimation. Assumptions used by the Company due to the lack of observable inputs may significantly impact the resulting fair value and therefore the Company’s results of operations.

**Russell Financial Services, Inc.**  
**Notes to Financial Statement**  
**December 31, 2008**

The inputs used by the Company in estimating the value of level 3 financial instruments include the original transaction price, recent transactions in the same or similar instruments or other transactions across the capital structure.

When observable prices are not available, the Company uses one or more valuation techniques (e.g., the market approach, the income approach or, the cost approach) for which sufficient and reliable data is available. Within level 3, the use of the market approach generally consists of using comparable market transactions, while the use of the income approach generally consists of the net present value of estimated future cash flows, adjusted as appropriate for liquidity, credit, market and/or other risk factors. The selection of appropriate valuation techniques may be affected by the availability of relevant inputs as well as the relative reliability of the inputs. The results of the application of the various techniques may not be equally representative of fair value, due to factors such as assumptions made in the valuation.

**Fair Value Tabular Disclosures**

The following table summarizes the valuation of the Company's assets measured at fair value on a recurring basis using the SFAS 157 fair value hierarchy levels as of December 31, 2008:

	Level 1	Level 2	Level 3	Total
<b>Assets</b>				
Money market mutual funds	\$ 66,326,986	\$ -	\$ -	\$ 66,326,986

**4. Current and Deferred Income Taxes**

The tax effects of temporary differences that gave rise to the net deferred tax asset as of December 31, 2008 are presented below:

Deferred income tax assets	
Accrued long-term incentive plan	\$ 506,994
Accrued long-term compensation	30,997
Unrealized gain/loss	6,843
State deferred tax, net of federal tax benefit	<u>25,061</u>
Total deferred income tax assets	<u>569,895</u>
Deferred income tax liability	
Depreciation of fixed assets	<u>2,809</u>
Total deferred income tax liability	<u>2,809</u>
Total deferred income tax assets, net	<u>\$ 567,086</u>

Income taxes receivable from Russell as of December 31, 2008 are \$4,181,582 and are included in due from affiliates on the accompanying statement of financial condition, net of payables due to Russell.

**Russell Financial Services, Inc.**  
**Notes to Financial Statement**  
**December 31, 2008**

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**5. Employee Compensation Arrangements**

**LTIP**

The Company participates in the Russell LTIP covering eligible employees. The LTIP provides for the award of stock options, restricted stock units ("RSU"), and stock appreciation rights ("SAR") in Russell's common stock. The maximum number of shares of Russell's common stock that are issuable, or were issued and are outstanding, pursuant to awards under the LTIP or IPP may not, at any time, a) represent 20% or more of the "value" or "voting power" of all the issued and outstanding common stock at such time, or b) exceed 50,000,000 shares of common stock. Awards that are canceled, forfeited, terminated or otherwise settled by the holder or by Russell are then available for award under the LTIP, subject to the above limitations.

Awards granted under the LTIP are subject to the guidance of SFAS 123R which requires that all awards subject to the standard be classified as either equity or liability awards. SFAS 123R requires that compensation expense for all equity-classified awards be recorded based on their grant date fair value, and liability-classified awards be remeasured to fair value at each statement of financial condition date until the award is settled.

Grants of stock option and RSU awards to employees prior to December 31, 2008, made by Russell under the LTIP generally vest over three or four years in equal annual installments on February 16 each year after the date of grant. Grants of RSU awards to employees on or after December 31, 2008, under the LTIP generally cliff vest in three years after the date of grant on February 16. Grants of SAR awards to employees made by Russell under the LTIP generally vest over three years in equal annual installments on February 16 each year after the date of grant. Awards granted prior to December 31, 2008, will vest upon retirement for employees who are age 65 or older and have at least 5 years of Russell service or who are between the ages of 55 and 64, and the combination of the associate's age and service (each rounded up to the nearest full year) totals 70 or more. For awards granted on or after December 31, 2008, awards will vest upon retirement, except for when a participant retires in the calendar year of grant. Stock-based compensation expense for awards granted to individuals meeting the retirement eligibility requirements, or who will meet the age and service requirements within the applicable vesting period, is recognized over a required service period that is less than the stated vesting period. Stock options and SAR awards granted prior to December 31, 2008 generally expire five years from the date of grant. Stock options granted on or after December 31, 2008 generally expire seven years from the date of grant, while SAR awards generally continue to expire five years from the date of grant.

For a 21-day period (or longer if determined by the Plan Administrator) that commences on the date in the first quarter of each fiscal year on which the per share fair value is communicated to a participant (hereinafter referred to as the "Annual Put Window"), holders of awards have the right to require Russell to repurchase ("put") vested awards or shares based on the then-current per share fair value of Russell's common stock, subject to a limit of 50% of the cumulative number of awards a participant has acquired under the LTIP as well as certain other limits discussed below. Holders of common stock received upon exercise of options or vesting of RSUs must hold the awards for at least six months and one day before they have the right to put such shares to Russell. Holders of SARs are not eligible to participate in the Annual Put Window until they are 100% vested in their SAR award.

**Russell Financial Services, Inc.**  
**Notes to Financial Statement**  
**December 31, 2008**

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Holders of vested stock options have the right to exercise such awards during two semi-annual exercise windows. The first exercise window in any fiscal year shall run concurrent with the Annual Put Window for that fiscal year, and the second exercise window shall terminate no later than six months and one day prior to the Annual Put Window for the following fiscal year. Each exercise window shall be a period of 21 days, which will commence on the date Russell communicates the per share fair value of Russell's common stock to a participant.

Russell estimates the fair value of stock option and SAR awards using the Black-Scholes option pricing model, which requires, among other inputs, an estimate of the fair value of Russell's common stock on the date of grant and the expected volatility of the common stock over the expected term of the related grants. Stock options are granted with an exercise price equal to the per share fair value of Russell's common stock at the date of grant. Russell determined that it was not practicable to calculate the volatility of its share price since Russell's securities are not publicly traded and therefore, there is no readily determinable market value for its stock. Therefore, Russell estimates its expected volatility based on reported market value data for a group of publicly traded companies, which it selects from certain market indices, that Russell believes are relatively comparable after consideration of their size, stage of lifecycle, profitability, growth, and risk and return on investment. Russell uses the average expected volatility rates reported by the comparable group for the expected terms estimated by Russell.

The expected terms of the stock option and SAR awards are derived from the average midpoint between the vesting and contractual terms. The risk-free rate for the expected term of the awards is based on the U.S. Treasury yield curve at the time of grant. The expected annual dividend yield is based on Russell's current dividend yield.

In connection with the adoption of the LTIP, Russell elected the straight-line method of allocating compensation expense over the requisite service period of the related awards. As stock-based compensation expense recognized in accordance with SFAS 123R is based on awards ultimately expected to vest, the expense included in the Company's statement of income for the year ended December 31, 2008 has been reduced by an estimated forfeiture rate of 3% for equity-classified awards and 5% for liability-classified awards.

For the year ended December 31, 2008, the Company recorded stock-based compensation expense under SFAS 123R of \$714,803 related to the LTIP. Of this expense, \$1,122,387 relates to equity-classified awards held by employees of the Company which has been recorded as a noncash deemed capital contribution from Russell and a reduction of expense of \$407,584 relates to liability-classified awards. As of December 31, 2008, the Company's total unrecognized compensation cost related to equity-classified awards accounted for in accordance with SFAS 123R is \$4,309,885, which will be recognized over the weighted-average remaining requisite service period of 2.51 years. In addition, as of December 31, 2008, the Company's total unrecognized compensation expense related to liability-classified awards outstanding under the LTIP is \$842,267, which will be recognized over the weighted-average remaining requisite service period of 2.14 years.

**Russell Financial Services, Inc.**  
**Notes to Financial Statement**  
**December 31, 2008**

The total deferred income tax benefit recognized in the Company's statement of income for stock-based awards for the year ended December 31, 2008 was \$184,302. In 2008, the Company did not realize any excess tax benefits from stock-based payment arrangements. The Company's historical SFAS 123R windfall tax benefit pool upon adoption of that standard was zero given its adoption under the prospective transition method. The Company utilizes the with-and-without approach to calculate realized windfall tax benefits from share-based compensation awards. The Company records interest and penalties on amounts due to tax authorities as a component of income tax expense in its statement of income. In accordance with Emerging Issues Task Force ("EITF") Issue No. 00-16, *Recognition and Measurement of Employer Payroll Taxes on Employee Stock-based Compensation*, the Company records a liability for the employer's portion of payroll taxes on stock-based compensation under the LTIP on the date of the event triggering the measurement and payment of the tax to the taxing authority.

Detail related to stock option and RSU activity under the LTIP, representing the Company's equity-classified awards under SFAS 123R, is as follows:

	<u>Stock Options</u>	
	<u>Number of Shares Under Option</u>	<u>Weighted- Average Exercise Price</u>
Outstanding at January 1, 2008	153,768	\$ 15.12
Granted	783,561	7.44
Forfeited / expired	(47,233)	15.88
Transfers in	194,855	15.40
Transfers out	(24,801)	15.12
Outstanding at December 31, 2008	<u>1,060,150</u>	9.46
Exercisable as of December 31, 2008	<u>89,284</u>	15.12

	<u>Restricted Stock Units</u>	
	<u>Number of Units</u>	<u>Weighted- Average Grant Date Fair Value</u>
Outstanding at January 1, 2008	51,255	\$ 15.12
Granted	261,187	7.44
Vested	(33,068)	15.12
Forfeited	(12,437)	16.08
Transfers in	64,951	15.40
Transfers out	(8,267)	15.12
Outstanding at December 31, 2008	<u>323,621</u>	8.94

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The fair value of employee stock option awards granted during the year ended December 31, 2008 was estimated using the Black-Scholes option pricing model with the following assumptions:

Risk-free rate	1.78% – 2.13%
Expected term	3.5 – 4.63 years
Expected dividend yield	0% – 1.5%
Expected volatility	26.97% – 44.33%

The estimated weighted-average grant date fair value of all stock options granted during the year ended December 31, 2008 was \$2.32. No equity-classified awards were exercised during the year ended December 31, 2008. The total fair value of RSUs vested during the year ended December 31, 2008 was \$567,778.

Detail related to SAR activity under the LTIP, representing the Company's liability-classified awards under SFAS 123R, is as follows:

	<u>Stock Appreciation Rights</u>	
	<u>Number of</u> <u>Shares</u> <u>Under Right</u>	<u>Weighted-</u> <u>Average</u> <u>Exercise Price</u>
Outstanding at January 1, 2008	180,154	\$ 15.82
Granted	757,496	11.89
Forfeited / expired	(19,841)	15.12
Exercised	(9,920)	15.12
Transfers in	222,531	15.50
Transfers out	(51,601)	15.99
Outstanding at December 31, 2008	<u>1,078,819</u>	13.01
Exercisable as of December 31, 2008	<u>-</u>	-

The fair value of SAR awards as of December 31, 2008 was estimated using the Black-Scholes option pricing model with the following assumptions:

Risk-free rate	0.79% – 1.57%
Expected term	2.13 – 4.13 years
Expected dividend yield	0
Expected volatility	46.23% – 60.67%

The aggregate amount paid by Russell during the year ended December 31, 2008 to settle SARs held by employees of the Company was \$1,290. As of December 31, 2008, the Company has an aggregate recorded liability of \$130,750 related to its liability-classified awards outstanding under the LTIP, included within incentive compensation liabilities in the Company's statement of financial condition.

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The following table summarizes information about all stock options and SARs outstanding under the LTIP as of December 31, 2008:

	Shares Subject to Options/Rights Outstanding	Weighted- Average Remaining Contractual Life (Years)	Weighted- Average Exercise Price	Total Intrinsic Value <sup>(1)</sup>
<b>Exercise price</b>				
\$5.33	968,785	6.46	\$ 5.33	
\$15.12	545,625	3.13	15.12	
\$15.25	78,688	4.13	15.25	
\$17.17	506,688	4.13	17.17	
\$19.14	39,183	3.13	19.14	
\$5.33 – \$19.14	<u>2,138,969</u>	4.91	11.25	\$ -
Vested and exercisable	<u>225,512</u>	3.26	15.63	-
Vested and expected to vest	<u>2,035,828</u>	4.88	11.36	<u>\$ -</u>

<sup>(1)</sup> The total intrinsic value represents the aggregate estimated fair value of Russell's common stock issuable and the aggregate exercise price available.

**OCAP**

The Company participates in Russell's OCAP covering eligible employees. As discussed in Note 1, Russell implemented the OCAP in February 2007. The OCAP provides for the award of a cash bonus, denominated in the participant's local currency at the time of grant, that will increase or decrease in value based on the changes in the per-share fair value of Russell's common stock. Awards made to employees by Russell under the OCAP cliff vest after three years and are paid at the end of the vesting period. This type of award is similar to a phantom stock unit that is subject to the guidance of SFAS 123R, which requires that all awards be classified as either equity or liability awards. As OCAP awards are ultimately settled in cash, the awards are liability-classified and will be remeasured to fair value at each reporting period until settled. As of December 31, 2008, the Company has an aggregate recorded liability of approximately \$88,564 related to its OCAP awards, included within incentive compensation liabilities in the Company's statement of financial condition.

**Incentive Payment Plan**

Effective April 27, 1999, the Incentive Payment Plan ("IPP") was established whereby employees of Russell and its subsidiaries, including the Company, could earn aggregate awards of up to 50 million shares of Russell's callable puttable common stock. The number of shares issued under the IPP was determined by Russell's cumulative earnings before interest, taxes, depreciation and amortization ("EBITDA"), as defined by the IPP, during a five-year period beginning January 1, 1999. As of April 15, 2004, a total of 42.25 million shares of callable puttable common stock were outstanding based on this determination. No additional shares of callable puttable common stock will be issued under the IPP.

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During the Annual Put Window, a holder of an award issued under the IPP can put up to an annual limitation of 25% of cumulative total of shares that holder has received under the plan. Upon the death, disability or employment termination of a holder of an award issued under the IPP, the holder has the right to put all such awards (but not less than all) to Russell, and Russell has the right to call all such awards (but not less than all) from that holder, each at a formula-derived price as stated in the IPP.

Subject to the approval of Russell's Board of Directors, Northwestern Mutual Life Insurance Company may affect these share repurchases in lieu of Russell. The put and call rights terminate upon an initial public offering of Russell's common stock. In the event of a change in ownership control of Russell, Northwestern Mutual Life Insurance Company has the right to call all awards then outstanding under the IPP at a formula-derived price, and each holder of such awards has the right to put all such awards to Northwestern Mutual Life Insurance Company at a formula-derived price.

The Company accounts for the IPP in accordance with SFAS 123R. Compensation expense related to these shares is based on changes in the formula-derived price of the outstanding awards. The expense recorded by the Company is considered a deemed capital contribution from Russell. No related liability is recorded in the Company's statement of financial condition as the contractual obligation for cash settlement of the shares remains with Russell.

The following table reflects the activity for the year ended December 31, 2008 of shares of callable puttable common stock held by employees of the Company:

	<b>Shares of Callable Puttable Common Stock</b>
Outstanding at January 1, 2008	708,310
Net transfers in (out)	571,291
Settlements	<u>(589,799)</u>
Outstanding at December 31, 2008	<u>689,802</u>

The aggregate value of outstanding shares of callable puttable common stock held by employees of the Company as of December 31, 2008 is \$3,635,257. The aggregate amount paid by Russell during the year ended December 31, 2008 to settle shares held by employees of the Company was \$11,931,634. Compensation expense reversal recorded by the Company related to shares of callable puttable common stock outstanding was \$5,731,071 for the year ended December 31, 2008. The Company recorded a related noncash deemed capital distribution to Russell of \$5,731,071 for the year ended December 31, 2008.

**Incentive Share Plan**

The Company participates in Russell's ISP covering eligible employees. Effective January 1, 2004, the ISP was established by Russell. The ISP is a cash-based, long-term incentive program for employees of the Company. From 2004 through 2006, ISP units were awarded annually to selected employees. The plan does not have a definitive end date; however, Russell's Board of Directors has not made any grants in 2008 and does not anticipate further grants.

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The value of ISP units is determined by the increase or decrease in Russell's annual EBITDA as defined by the ISP, over the four years beginning with the year the award is made. The units vest at the rate of 25% per calendar year over the four-year period. The vested appreciation of the ISP units will be paid in cash in the year following the end of the four-year vesting period, or upon the participant's termination of employment from Russell, whichever occurs earlier. In 2008, the Company allowed a two year extension for payment of the 2005 grants and a one year extension for the payment of the 2006 grants. Compensation expense reversal under the ISP was approximately \$6,226,000 for the year ended December 31, 2008. As of December 31, 2008, the Company has recorded no liability related to its ISP awards as the formula-derived price of the ISP units had declined to zero.

**6. Benefit Plans**

**Retirement Plan**

The Company participates in the Russell defined contribution retirement plan (the "Plan") covering eligible employees. The Plan allows for contributions to be made out of the Company's net operating profits at the discretion of the Russell Board of Directors. Employees may also contribute a percentage of their compensation as defined by the Plan.

**Discretionary Bonuses**

The Company pays discretionary bonuses to its employees based on a percentage of Russell's consolidated operating income, as defined.

**7. Related Party Transactions**

Under a joint purchasing agreement, Russell processes payments for the direct expenses of the Company. Under a joint paymaster agreement, Russell processes payroll transactions for the Company. Additionally, Russell allocates certain negotiated charges to the Company such as office space, equipment and insurance charges. The Company reimburses Russell monthly for these expenses. Amounts payable to Russell for these charges are \$3,134,665 at December 31, 2008 and are netted against receivables due from Russell in due from affiliates on the accompanying statement of financial condition.

Under an expense sharing agreement, certain charges, such as corporate overhead, incurred by Russell on the Company's behalf are not allocated to the Company.

Russell and its subsidiaries follow a transfer pricing methodology governed by the amended and restated Master Intercompany Agreement ("Agreement"). The methodology, a Residual Profit Split, is intended to conform to the relevant U.S. and local country tax laws and the Organization of Economic Cooperation and Development guidelines. As a participating member to the Agreement, the Company receives an intercompany recovery (charge) based on the amount calculated under the Residual Profit Split. Russell acts as the monthly settlement agent for any payments or disbursements among the participating members associated with the effects of the Residual Profit Split. The amount recorded as an intercompany charge for transfer pricing in the statement of income under the agreement for the year ended December 31, 2008 was \$400,464. The amount due to Russell at December 31, 2008 is \$2,900,000 and are presented in the accompanying statement of financial condition as due to affiliates.

**Russell Financial Services, Inc.**  
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The Company has entered into an Expense Sharing and Support agreement, dated January 1, 2008, with RIMCo. Under this agreement, RIMCo agrees to compensate the Company for providing marketing, distribution and client service activities with respect to the RIC and RIF funds. For the year ended December 31, 2008 these fees were approximately \$104,155,000 and are recorded as distribution and shareholder servicing revenue. There are no amounts receivable from RIMCo for these fees at December 31, 2008.

The Company has entered into a Sales and Service agreement, dated January 1, 2008, with a related party. Under this agreement, the related party agrees to compensate the Company for providing sales and client support services for their products. For the year ended December 31, 2008, these fees were \$8,719,336 and are recorded as distribution and shareholder servicing revenue. Amounts payable to this related party for these fees are \$929,779 at December 31, 2008 are presented in the accompanying statement of financial condition as due to affiliates.

The Company has entered into a Referral and Service agreement, dated January 1, 2008 with a related party. Under this agreement, the related party agrees to compensate the Company for introducing prospective clients and investors along with providing client support services. For the year ended December 31, 2008, these fees were approximately \$18,643,000 and are recorded as distribution and shareholder servicing revenue. There are no amounts receivable from this related party for these fees at December 31, 2008.

The Company has entered into a placement agency agreement with Russell Institutional Funds Management, LLC ("RIFM") with respect to the Russell Institutional Funds, LLC ("RIFL"). Under this agreement, RIFM agrees to compensate the Company to solicit and receive offers to subscribe for interests in RIFL. For the year ended December 31, 2008, these fees were approximately \$84,000 and are recorded as distribution and shareholder servicing revenue. Amounts receivable from RIFM are \$83,957 at December 31, 2008 and are presented in the accompanying statement of financial condition as due from affiliates.

The Company has entered into a distribution agreement with Northwestern Mutual Investment Services LLC, a subsidiary of Northwestern Mutual Life Insurance Company, with respect to RIC and RIF. For the year ended December 31, 2008, these fees were approximately \$5,340,000 and are included in distribution and shareholder servicing fee revenue in the accompanying statement of income. The amount payable to Northwestern Mutual Life Insurance Company is \$1,190,305 as of December 31, 2008 and is presented in the accompanying statement of financial condition as due to affiliates.

The Company has entered into a sales support agreement and a shareholder servicing agreement with RIC. Substantially all fees received in connection with these agreements are remitted to financial intermediaries. For the year ended December 31, 2008, these fees were \$69,767,274 and are recorded as distribution and shareholder servicing fee revenue. Amounts receivable for these services are \$4,189,931 at December 31, 2008 and are presented in the accompanying statement of financial condition as distribution fees receivable.

**8. Commitments**

The Company leases office space under noncancelable lease agreements expiring between 2011 and 2012. These leases provide for annual rental increases based on various price indices. Total rent expense, inclusive of corporate office space rent allocations recorded by the Company for the year ended December 31, 2008 was \$4,064,551 and is included in occupancy and office expense on the accompanying statement of income.

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At December 31, 2008, the Company's remaining commitment for the minimum lease payments for these noncancelable operating leases is as follows:

<b>Years ending December 31,</b>	
2009	\$ 245,531
2010	252,818
2011	120,660
2012	96,274
	<hr/>
	<b>\$ 715,283</b>

**9. Concentration of Risk**

Substantially all revenue earned and accounts receivable outstanding of the Company is from affiliated entities.

**10. Guarantees**

In the normal course of business, the Company enters into contracts that contain a variety of representations which provide general indemnifications. The Company's maximum exposure under these arrangements is unknown as this would involve future claims that may be made against the Company that have not yet occurred. However, the Company expects the risk of loss to be remote.

**11. Contingencies**

The Company has various claims and legal matters occurring in the normal course of business, which management, based upon the advice of legal counsel, does not expect to have a material adverse effect on the financial condition, results of operations or cash flows of the Company.

**12. Subsequent Event**

Subsequent to December 31, 2008, the Company declared and paid a \$30,000,000 return of capital to RIMCo.

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