This memorandum is intended to remind Philadelphia Stock Exchange (“Phlx” or the “Exchange”) Members, Member Organizations, Participants and Participant Organizations (collectively “Member Organizations”) of certain requirements regarding the creation and maintenance of accurate books and records, the use of proper supervisory procedures, and various regulatory requirements including, but not limited to, utilization of accrual accounting, mandatory annual compliance meetings, temporary capital contributions, office locations, written supervisory procedures, and registration of associated persons. While these requirements apply to all Member Organizations, this memorandum is specifically targeted at those Member Organizations for which the Exchange is the designated examining authority (“DEA”).

**Books and Records**

Member Organizations are required to maintain current and accurate books and records at all times that enable a Member Organization to monitor net capital (or liquid assets for those Member Organizations that are exempt from the Net Capital Rule or subject to Phlx Rule 703) on a moment-to-moment basis. At a minimum all Member Organizations must maintain a trial balance and compute a net capital/net liquid asset computation on a monthly basis. All assets and liabilities of a Member Organization must be reconciled, and proof of any reconciliation must be maintained (i.e., checking account statements, clearing account statements, invoices for services rendered and/or received, etc.) All Member Organizations must comply with the recordkeeping requirements pursuant to Exchange Act Rules 17a-3 and 17a-4, regardless of the business mix of the Member Organization, or the extent of business conducted by the Member Organization.

Exchange Act Rule 17a-4 (d) requires Member Organizations to maintain, for the life of the enterprise, all Forms BD, all Forms BDW, all amendments to these forms, all licenses or other documentation showing the registration of the Member Organization with any securities regulatory authority. Member Organizations should retain the information noted above along with partnership or corporation articles in a readily accessible file.
Member Organizations that utilize trade date basis for record keeping are in compliance with the AICPA Guide for Audits of Brokers and Dealers in Securities, while broker-dealers that utilize the settlement date basis of recordkeeping are in compliance with the Guide only if the difference between trade date and settlement date accounting is not material. When a methodology is utilized, it must be utilized constantly through the Member Organizations operation. A Member Organization must consistently utilize its chosen accounting methodology so all positions are valued on the same date basis.

When a Member Organization utilizes settlement date accounting there are two important caveats:

- If there would be a material difference in a Member Organization’s net capital (or liquid asset) computation between trade date and settlement date accounting, the net capital (or liquid asset) computation must be computed utilizing trade date; and,
- If there is a material difference on more than an occasional basis (i.e., twice in a six month period), consistent use of trade date accounting is required going forward.

Any change in a Member Organization’s accounting methodology must be communicated in writing to its DEA.

**Accrual Method of Accounting**

All Member Organizations are required to utilize the accrual method of accounting. Accrual accounting ensures a proper matching of revenue and expenses and provides an accurate real-time reflection of a Member Organization’s financial condition. At the end of a month (or at any point during the month) a Member Organization’s record of receivables and payables should reflect all revenue earned (but not received at the end of the month), and all liabilities incurred (but not paid at the end of the month). Member Organizations should typically accrue for payables including Phlx bill, and other recurring expenses of the member organization. (i.e., costs for accounting work, legal fees, utilities, communication systems, etc.)

The Exchange’s Examinations Department staff will closely scrutinize Member Organization filings that do not reflect accrued liabilities. Over the past few years, the Department has noted an increasing number of instances in which Member Organizations have failed to accrue for some or all expenses incurred during a monthly trial balance period. While recent educational efforts for new members have been initiated, it is expected that Member Organizations utilized qualified persons for compliance with financial condition and financial filing related matters. While employment of a full-time Financial and Operational Principal (“FinOP”) is not generally required under Exchange rules, Member Organizations and encouraged to utilize qualified FinOPs base on the complexity of computations and/or the ability of persons currently designated to compute capital computations. Regardless of the means utilized, a Member Organization, and its management, is responsible for violations of Federal Securities Laws and Phlx Rules.

**Charges against Securities Positions**

When determining net capital or liquid assets, Member Organizations must determine the appropriate charge required to be applied against each individual securities position. This charge is commonly referred to as a “haircut,” but charges can also include “undue
concentration”, “limited market value,” and a non-allowable asset status if the position is deemed “non-marketable.” Member Organizations should know the difference between securities positions acquired through market making and proprietary (or customer like) trading, as haircuts and other charges don’t apply to market making positions but do apply to non-market making positions. There should be clear and full communication between the trading personnel and the book keeping personnel at the Member Organization to determine the correct classification of each position and the appropriate charge. The Exchange’s Examinations Department staff consistently work with Member Organization personnel during routine examinations to communicate proper classification of positions, but in a few instances the staff has noted continued failures to correctly calculate charges. Repeat violations are often subject to serious disciplinary actions; therefore Member Organizations should ensure that proper classification and charges are applied to securities positions.

**Annual Compliance Meeting**

Phlx Rule 748(e)(i) requires all Member Organizations to conduct an annual compliance meeting with all associated personnel. The annual compliance meeting must address compliance matters relevant to the activities of the employees, or associated persons. Such meetings should be documented with, at a minimum, a list of attendees and an agenda covering scope of the meeting. While it is understandable that certain topics may be addressed several years in a row, Member Organizations should ensure that annual meetings address current issues and that such meetings and new topics are appropriately evidenced.

**Annual Audit Requirement**

Pursuant to subsection (1)(iii) of Rule 17a-5(d) of the Exchange Act, Member Organizations that are members of a national securities exchange and have transacted a business in securities solely with or for other members of a national securities exchange and have not carried customer accounts, are exempt from Rule 17a-5(d).

This exemption will apply to a Phlx Member Organization that operates primarily as an on-floor specialist, market maker or a floor broker and executes 75% or more of its transactions directly relating to its primary business on the floor of the Exchange.

Therefore, Member Organizations conducting 25% or more of their total transactions at any time, which are not directly related to its primary business as on-floor specialist, market maker or floor broker will be required to engage an independent public accountant and file an Annual Audit pursuant to Rule 17a-5. Transactions not directly related to a primary business on the floor include, but are not limited to: transactions occurring in a customer or investment account; proprietary trading and margin transactions resulting in the application of Regulation T.

Member Organizations claiming an exemption from Rule 17a-5(d) are reminded of the obligation to maintain evidence supporting their qualification for the exemption.

Member Organizations designated to the Philadelphia Stock Exchange ("Phlx" or “Exchange”) are reminded to file their Annual Audit with the Exchange's Examinations Department on a timely basis, which is due on **March 2, 2006**, for Member Organizations with a calendar yea-rend. Member Organizations requiring an extension must make a request, in writing, prior to the filing due date. Additionally, Member Organizations are
reminded of the requirement that they engage an independent and certified public accountant that is duly registered in good standing under the laws of the accountant’s home state.

**Temporary Capital Contributions**
The Securities and Exchange Commission ("SEC") has issued a No-Action Letter regarding the capital contributions made to Member Organizations by individual investors and how to properly treat these capital contributions for net capital computations.

Member Organizations engaging in proprietary or agency trading of securities, including, but not limited to, equities, preferred securities, convertible debt securities or options off the floor of the Exchange and structured as Limited Partnerships or Limited Liability Companies are primarily effected by this SEC interpretation.

The SEC states in its letter that if an individual investor contributes capital to a broker or dealer with the understanding that this capital contribution may be withdrawn at the option of the individual investor, **then this contribution may not be included in the firm's net capital computation and must be classified as a liability.** Further, it is the opinion of the SEC that any withdrawal of capital by the individual investor within a period of one year shall be presumed to have been contemplated at the time of the contribution and relevant financial filings must be restated to reflect the impact of the non-allowable asset value of the contribution.

**Office Locations**
Exchange Act Rule 17a-3(a)(21) requires that each Member Organization record the person, by name or title, at each office who, without delay, can explain the types of records the Member Organization maintains at that office, as well as the information contained in such records. Member Organizations should appoint a qualified and knowledgeable person at each office location who can effectively explain the nature of records made and kept at that office. Member Organizations should make, and keep current, a list containing the name or title of each person responsible at each office.

**Written Supervisory Procedures**
Exchange Act Rule 17a-4(e)(7) requires Member Organizations to maintain compliance, supervisory, and procedures manual, including any updates, modifications, and revisions to the manual until three years after the termination of the use of the manual. Compliance with this rule will at a minimum require Member Organizations to date and/or otherwise identify different versions of their manuals. Member Organizations should be able to demonstrate what exact manual governed an operation during any specific time during the preceding three years.

**Associated Persons Records & Written Agreements**
Member Organizations should pay close attention to the distinction between someone performing solely clerical or ministerial duties versus someone participating in a securities transaction or facilitating a securities transaction. Persons functioning as Floor Brokers, Stock Execution Clerks, Account Coverage Clerks or anyone involved or party to the execution of a securities transaction is considered an associated person for purposes of this
Paragraph (ii) of the Rule 17a-3(a)(19) requires that Member Organizations maintain records of all agreements pertaining to the relationship between each associated person and the Member Organizations, including a summary of each associated person’s compensation arrangement or plan and, to the extent that compensation is based on factors other than remuneration per trade, the method by which the compensation is determined. Member Organizations should make, and keep current, written copies of employment agreements or other records that evidence and or explain compensation arrangements. Member Organizations should further be prepared to provide regulators with written documentation that clearly describes how and why all associated persons are compensated. While not all persons functioning as “clerks” are considered associated persons by the rule, Member Organization should keep similar records related to such persons since the Examinations Department staff routinely requests explanations of clerk compensation.

While Member Organizations are responsible for complying with applicable rules and regulations, the Examinations Department staff is receptive to answering questions about financial and operational matters. For questions regarding this memorandum, or other applicable matters, please contact the Department’s general number at (215) 496-5188, or William Bunting, Director Examinations, at (215) 496-5401.