Memorandum No. 0368-08

MEMORANDUM

To: **All Members, Member Organizations, Participants and Participant Organizations**

From: **William A. Bunting, Director, Examinations Department**

Re: **Books and Records Informational**

Date: **February 21, 2008**

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, futures charges, mandatory annual compliance meetings, annual audit requirements, written agreements, Regulation SHO, anti-money laundering compliance program, electronic communications, registration, and written supervisory procedures. 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.

All XLE Participants that act as brokers on XLE, and all Member Organizations in general, are reminded of their obligation to make and maintain the memorandum described in Exchange Act Rules 17a-3(a)(6) and 17a-4(b)(1) for all orders and partial orders that they enter on XLE in which they act as brokers.

The memorandum must contain, but is not limited to, the following information: a record of each brokerage order, given or received for the purchase or sale of securities, whether executed or unexecuted. The memorandum shall show the terms and conditions of the order or instructions and any modification or cancellation thereof; the account for which entered, and the time the order was received.

The order memorandum, with information contained above must be maintained, whether executed, unexecuted or canceled.

Likewise, all Member Organizations are reminded of their obligation to make and maintain a memorandum of each purchase and sale for the proprietary account of a Member Organization as described in Exchange Act Rules 17a-3(a)(7) and 17a-4(b)(1).

All Member Organizations are reminded to accurately report and categorize their revenue and expense items on its FOCUS Report submissions to the Exchange; and are reminded that accurate revenue and expense tracking and classification is not only required per the reporting rules, but also may impact various other rules including Section 11(a) of the Securities Exchange Act of 1934 and possibly required net capital.

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 **all payables** including Phlx bills, and other recurring expenses of the Member Organization (i.e., costs for accounting work, legal fees, utilities, communication systems, etc.).

Exchange Act Rule 17a-4 requires that every Member Organization subject to Exchange Act Rule 17a-3 shall preserve for a period of not less than three years, the first two years in an easily accessible place, certain records required to be made pursuant to Exchange Act Rule 17a-3, including all bills receivable and payable, paid or unpaid, relating to the business of the Member Organization.

It is expected that Member Organizations utilize qualified persons for compliance with financial condition and financial filing related matters. While employment of a full-time Financial and Operations Principal ("FinOP") is not generally required under Exchange rules, Member Organizations are encouraged to utilize qualified FinOPs based 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 computing 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. Repeat violations in this area are often subject to serious disciplinary actions; therefore Member Organizations should ensure that proper classification of securities and resulting charges are applied.

Futures charges

Member Organizations must comply with specific requirements when open futures contracts and granted (sold) commodity options are held in proprietary accounts carried by the broker or dealer that are not covered by a position held by the broker or dealer, or are not the result of a "changer trade" made in accordance with the rules of a contract market.

A broker or dealer, which is a member of a self-regulatory organization, must produce a provision of 150% of the applicable maintenance margin requirement of the applicable board of trade or clearing organization, whichever is greater.

These charges must be applied as part of the Member Organization's computation in determining its tentative net capital prior to the Member Organization's deductions for haircuts and undue concentration charges.

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. The Member Organization's verification can be electronic, in that the individual attended the annual compliance meeting through a video conference or verification that the individual received the annual compliance material electronically. The Member Organization should verify that the annual compliance meeting material was received and reviewed, and a record is maintained by the Member Organization documenting this receipt. Such meetings should be documented with, at a minimum, a list of attendees and an agenda covering the 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 meeting 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[1] 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, XLE participant, 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, XLE participant, or floor broker will be required to engage an independent public

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[1] Based on conversations between Exchange and SEC staff, it is the Exchange's understanding that Member Organizations that participate directly in NASDAQ, as a NASDAQ member or market maker are subject to the annual audit requirement despite the fact that NASDAQ is now a national securities exchange.

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 Phlx are reminded to file their annual audit with the Exchange's Examinations Department on a timely basis, which is due on **February 29, 2008**, for Member Organizations with a calendar year-end. 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.

Member Organizations who have not filed their annual audit by the due date or revised due date if an extension has been granted, will be subject to a late fee for each week or any part thereof that the annual audit has not been filed.

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.

Member Organizations, who have an association with a FinOP or have contracted with an accountant independent of the Member Organization, are not exempted of their supervisory responsibility as to the Member Organization's books and records, financial reporting, and net capital/net liquid asset requirements of the Member Organization.

All Member Organizations must monitor for and make good faith efforts to detect and prevent any and all electronic eavesdropping by its personnel. The Member Organization must set forth prohibitions against electronic eavesdropping on the trading and/or trading strategies of other broker dealers, hedge funds, banking institutions, and investment advisor organizations. In general, the written supervisory procedures must address the Member Organization's policy regarding use of non-public information and modern communication devices, (i.e., e-mail, instant messaging, squawk boxes, video conferencing, etc.).

Any Member Organization that employs a specialist clerk that performs any function other than a solely clerical or ministerial function shall, prior to performing any function as a specialist clerk, shall submit to the exchange, written supervisory procedures relating to such specialist clerk's activities.

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 rule under Exchange Act Rule 17a-3(g)(4).

Paragraph (ii) of Rule 17a-3(a)(19) requires Member Organizations to maintain records of all agreements pertaining to the relationship between each associated person and the Member Organization, 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 Organizations should keep similar records related to such persons since the Examinations Department staff routinely requests explanations of clerk compensation.

In Accordance with Exchange Act Rules 17a-3 & 17a-4, Member Organizations are required to maintain and preserve all written agreements between itself, its employees, associated persons, officers and partners, and third parties. Such examples of these agreements are; loan agreements, expense sharing agreements, management agreements, joint back office agreements, etc.

Regulation SHO

In June 2004, the Securities and Exchange Commission ("Commission") adopted Regulation SHO, which provides a new uniform regulatory framework governing short selling of securities. Regulation SHO established uniform locate, delivery requirements and uniform marking requirements for sales of all equity securities. Regulation SHO requires broker dealers to mark sales in all equity securities as "long", "short", or "short exempt". Member Organizations may rely on the masking provision of marking its orders short exempt for orders routed to a market center, and must also provide for this in its Written Supervisory Procedures.

Regulation SHO requires that a broker dealer prior to effecting a short sale in any equity security to "locate" securities available for borrowing. A broker dealer cannot enter into short sales unless the broker dealer has (1) borrowed the security, or entered into an arrangement to borrow the security, or (2) has reasonable grounds to believe that the security can be borrowed so that it can be delivered. An "Easy to Borrow" list may provide a reasonable ground, provided that it is less than 24 hours old. All locates must be made prior to effecting a short sale. All locates that are not evidenced by the utilization of the Easy to Borrow List, the Member Organization must maintain and provide physical evidence of such locates to the Exchange upon request. The rule provides for a limited exception from the locate provision, including short sales effected in connection with bona-fide market making (specialists and option market making).

Anti-Money Laundering Compliance Program

All Member Organizations are subject to the provisions of the Patriot Act and Phlx Rule 757, Anti-Money Laundering Compliance Program. Member Organizations are reminded that annual inspections are only required to be conducted at Member Organizations that conduct a business with public customers, while bi-annual inspections are required for Member Organizations that limit their business to proprietary trading and/or trading exclusively with and for other brokers or dealers registered with the Commission. These annual and bi-annual inspections are to be conducted by an independent and qualified individual or entity.

Member Organizations are to conduct training for appropriate personnel on a recurring basis, and should occur at least on an annual basis. The training should encompass potential unusual or suspicious activity. <u>The training material utilized in the annual training sessions must be maintained and preserved as part of the Member Organization's records.</u>

<u>Electronic Communications</u>

Exchange Act Rule 17a-4(b)(4) requires that Member Organizations must retain e-mails, <u>instant messages</u>, and any other electronic communications, which include both inter-office and external electronic communications, which are related to the business of the Member Organization. All Member Organizations must have adequate procedures that outline the supervisory system utilized to supervise the usage by its personnel as it relates to the Member Organization's business.

A Member Organization's Written Supervisory Procedures should state a prescribed frequency, timeliness and quantity parameters.

Member Organizations may choose to utilize a reasonable percentage sampling technique, whereby some percentage of its electronic communications is reviewed. There is no prescribed minimum or fixed percentage that is required by regulation. The amount of electronic communications chosen for review must be reasonable given the circumstance (member size, nature of business, individual employee circumstance). Member Organizations can also set their sampling based on branch office, department, business unit, and each individual. The Member Organization should not limit itself to the same percentage for each employee, as those employees with disciplinary history or subject to special supervision may warrant a review encompassing a higher percentage of E-Mails. Member Organizations have the flexibility to design supervisory review procedures for electronic communications that are appropriate to each Member Organization's business model, where the manner of review could be automated, manual review or a combination of the various methods.

The Member Organization's procedures should identify the person(s) responsible for conducting the reviews.

The frequency of reviews may vary depending on the business of the Member Organization. The frequency of the review should be related to the type of business conducted. Such items to be considered are: market sensitivity of the business activity, the scope of activities, geographical location of the activities, and the volume of communications.

Member Organizations must evidence their retention and reviews, whether electronically or on paper, and must be able to demonstrate that such reviews were conducted. The evidence of such reviews should identify the reviewer, the communication that was reviewed, the date of the review, and steps taken as a result of any significant regulatory issues that were identified during the course of the review. The opening of the communication is not considered a sufficient review.

Member Organizations that utilize cellular or cordless telephones for their business on the Floor must maintain their cellular or cordless telephone records, including logs of calls placed, for a period of not less than a year. The Exchange reserves the right to request and examine such telephone records.

<u>Registration</u>

Any Member Organization that is required to file Form U4, Form U5 or Form BD pursuant to Exchange Rules 600, 604, or 620, or the Securities Exchange Act of 1934 and the rules promulgated thereunder, is required to amend the applicable Form U4, Form U5 or Form BD to keep such forms current at all times. Member Organizations shall amend Form U4, Form U5 or Form BD not later than thirty (30) days after the filer knew or should have known of the facts which gave rise to the amendment.

Any Member Organization that is required to have its personnel fingerprinted as a result of their access to original books and records must submit their fingerprint submission to WEB CRD for processing.

Any Member Organization whose personnel are required to register with WEB CRD, and are not required to register such personnel as a Member of the Exchange and/or a general securities representative, must register such personnel as a Non Registered Fingerprint Person.

<u>Off Floor Activity</u>

As a reminder, the Exchange does not recognize or allow Member Organizations registered as ROTs to conduct "Off-Floor" market making operations. While Phlx Rule 1014 addresses the ability for an ROT to conduct a transaction from off the Floor, only approved Remote Streaming Quote Traders are permitted to conduct market making away from the physical Exchange trading floor. Recently the Exchange has become aware that some Member Organizations mistakenly believed they were able to conduct "Off-Floor" market making. Such activity will likely result in the application of a litany of rules, regulations and fees, which Floor based ROTs are often exempt.

While Member Organizations are responsible for complying with applicable rules and regulations, the Examinations Department staff is receptive to receiving 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 Department, at (215) 496-5401.