

REGULATORY INFORMATION BULLETIN

RBE-02-02
April 25, 2002

TO: All ETP Holders

**FROM: Enforcement Department and Financial and Operational
Compliance Department**

SUBJECT: Supervision Obligations of ETP Holders

This regulatory bulletin reminds all ETP Holders that, pursuant to PCX Equities, Inc. (“PCXE”) Rule 6.18, they must supervise all persons associated with them. See Regulatory Bulletin Equities 01-02. To fulfill this requirement, all ETP Holders must have written supervisory procedures and a system for applying those procedures. It is important to emphasize that all supervisory procedures must be in writing.¹ This bulletin provides guidelines for developing written procedures.²

The Regulation Division conducts examinations and surveillance to determine whether associated persons are being supervised properly. ETP Holders are subject to enforcement actions for failing to establish adequate written supervisory procedures and for failing to supervise adequately. Be aware that individual supervisors as well as ETP Holders are responsible for supervision.

To supervise properly, ETP Holders must do at least the following to ensure compliance with federal securities laws and the constitution and rules of the PCXE:

⇒ Establish and keep up-to-date written supervisory procedures and a system for implementing the procedures.

¹ Some ETP Holders have asked whether unwritten procedures that are regularly followed are sufficient to evidence supervision. They are not. All of the supervisory procedures must be in writing.

² In addition to PCXE Rule 6.18, the Securities Exchange Act of 1934 (“Exchange Act”) authorizes the Securities and Exchange Commission (“SEC”) to sanction brokers, dealers and supervisors if they fail “reasonably to supervise” persons subject to their supervision who violate the federal securities laws. See Sections 15(b)(4)(E) and 15(b)(6) of the Exchange Act. They will not be found to have failed reasonably to supervise if (1) they have established reasonable supervisory procedures and a system for applying the procedures and (2) they have reasonably discharged their responsibilities under those procedures.

- ⇒ Designate and identify to the PCXE a person or persons responsible for each area of supervision.
- ⇒ Determine whether persons are qualified by virtue of experience or training to carry out their supervisory responsibilities.

To assist ETP Holders in preparing written supervisory procedures, PCXE staff has developed the following guidelines. **This guidance is meant as a starting point and does not purport to be comprehensive. Each ETP Holder must tailor its supervisory system and written procedures to that organization's structure and business activity.**³ At a minimum, written supervisory procedures must cover all of the following areas as appropriate:

I. FINANCIAL AND OPERATIONAL

ETP Holders must have written supervisory procedures to ensure compliance in each of the following areas and must designate one or more persons who will be responsible for each specific area:

A. Books and Records

1. ETP Holders must properly prepare and retain each of the following books and records that are required pursuant to Rules 17a-3 and 17a-4 of the Exchange Act for the type of securities business they conduct:⁴
 - Cash receipts and disbursements journals
 - Securities position records and reconciliation
 - Ledgers reflecting all asset, liability, income, expense and capital accounts (general ledgers)
 - Order tickets
 - Purchase and sales blotters
 - All written agreements
 - Monies borrowed/monies loaned ledgers
 - Repurchase and reverse repurchase agreements ledgers
 - Trial balances and net capital and/or net liquid assets computations
 - Balance sheets and income statements
2. ETP Holders must keep the following records for the life of the ETP Holder:
 - Clearing agreements

³ For example, these guidelines do not address the supervisory obligations of ETP Holders that carry customer accounts. See, e.g., PCXE Rule 9.2.

⁴ This list is not comprehensive and ETP Holders are encouraged to review Exchange Act Rules 17a-3 and 17a-4.

- Subordinated loan agreements
 - Articles of incorporation
 - Operating agreements
 - Partnership agreements
 - Broker-dealer applications (Forms BD) and amendments
3. ETP Holders must outline their record retention practices.
 4. ETP Holders must keep their Forms BD updated.
- B. Net Capital (Exchange Act Rule 15c3-1)
1. Net capital must be computed in compliance with the appropriate minimum amount for the type of activity the ETP Holder is involved in.
 2. In computing net capital, proper deductions must be made for non-allowable assets, haircuts on securities positions and undue concentration charges.
 3. Proper notice must be made to the SEC and appropriate self-regulatory organization when significant changes in capital occur.
 4. ETP Holders must be in net capital compliance at all times.
- C. Financial Reporting

Financial disclosures and reports required by the federal securities laws and PCXE rules must be submitted on time.

II. MARKET MAKING AND TRADING

ETP Holders must have written supervisory procedures to ensure compliance in each of the following areas and must designate one or more persons who will be responsible for each specific area:

- A. Trading Practices Prohibited by Federal Securities Laws and PCXE Rules:
1. Manipulation – This includes marking the close, prearranged trading, phantom orders, influencing the open and wash sales. A phantom order is an order or series of orders in which market participants enter buy or sell orders in a particular stock with the sole intention of artificially influencing the market. Phantom orders are usually cancelled prior to execution. Influencing the open is a manipulative practice similar to phantom orders in which the market participant is attempting to give the impression of increased trading volume and/or price behavior. Wash sales include transactions in which there is no change in beneficial

ownership and the trading is done for the purpose of creating a false or misleading appearance of active trading.

2. ETP Holders that have more than one market maker in a specific security must have policies and procedures in place that address the maintenance and enhancement of competition among such competing market makers.
 3. Parking of securities – This includes arrangements that conceal the true ownership of securities through the fictitious sale or transfer to an accommodator who agrees to later sell or transfer the securities to the true owner (or his agent).
 4. Front running.
 5. Insider trading - No proprietary account or employee account may misuse material nonpublic information. (See PCXE Rule 6.3.)
 - (a) Each new employee or associated person must be furnished with the most current version of the ETP Holder’s policies and procedures on insider trading and must sign an attestation adhering to and acknowledging an understanding of them. The attestation must be signed and returned to the ETP Holder within ten business days of the employee’s start date.
 - (b) Each ETP Holder must maintain an “Outside Brokerage Accounts List” documenting all employee and associated person accounts. Updates to the list must be made promptly and the list must be maintained for at least three years.
 - (c) A supervisor must be designated to review all activity reflected in the accounts listed in the “Outside Brokerage Accounts List.”
 - (d) All associated persons must be aware of the duty to report any potential violations to their supervisor and the PCXE's Surveillance Department.
- B. Limitation of Dealings – ETP Holders must have policies and procedures in place to ensure compliance with PCXE Rule 7.26. Specifically, market making firms seeking to engage in “Other Business Activities”⁵ must have in place sufficient Information Barriers between such activity and the market making activity.

⁵ “Other Business Activities” is defined under PCXE Rule 7.26(a) as (1) conducting an investment banking or public securities business; (2) making markets in the options overlying the security in which it makes markets; or (3) functioning as a General Authorized Trader.

- C. Short Sales – ETP Holders must comply with the short sale rules. These rules are designed to prevent illegal short selling. For purposes of PCXE Rule 7.16, ETP Holders must identify any short sale in listed securities as either “short” or “short sale exempt.” See Exchange Act Rule 10a-1. For Nasdaq securities, there is no bid test when the Archipelago Exchange (“Exchange”) is executing internally, but the bid test will apply if the order is routed to Nasdaq (e.g., against a Nasdaq dealer).
- D. Access to the Exchange – ETP Holders may only permit authorized users to access the Exchange. See PCXE Rules 7.29 and 7.30.

III. REGISTRATION REQUIREMENTS

ETP Holders must have written supervisory procedures to ensure compliance in each of the following areas and must designate one or more persons who will be responsible for each specific area:

- A. All associated persons must be properly qualified and registered with the PCXE, as applicable. If an associated person is registered with a national securities exchange or a registered securities association, the ETP Holder must verify the accuracy and completeness of all information contained in the person's Form U-4.
- B. Prior employment of newly associated persons must be verified before they begin working.
- C. ETP Holders must comply with Exchange Act Rule 17f-2 regarding the fingerprinting of registered and non-registered personnel.
- D. ETP Holders must file Forms BD, BDW, U-4 and U-5 and any amendments (including reportable disciplinary actions) in an accurate, complete and timely manner.
- E. ETP Holders must properly supervise any person subject to statutory disqualification under the Exchange Act but readmitted to membership pursuant to Exchange Act Rule 19h-1.

IV. GENERAL BROKERAGE OBLIGATIONS

ETP Holders must have written supervisory procedures to ensure compliance in each of the following areas and must designate one or more persons who will be responsible for each specific area:

- A. Order tickets must be accurately marked to convey the order type.

- B. Error accounts must be reviewed to determine whether they are being used appropriately.
- C. ETP Holders and associated persons may not engage in harassment, intimidation or other practices that may be considered anticompetitive.
- D. ETP Holders must comply with their order handling obligations, including rules concerning the following:
 - Limit orders
 - Priority
 - Firm quote
 - Best execution and due diligence
 - Trade reporting
 - Passive market making
 - Pricing and size conventions

V. SUPERVISORY STRUCTURE

- A. ETP Holders must designate and identify one or more persons to be responsible for a periodic review of the adequacy of the ETP Holder's overall supervisory system.
- B. ETP Holders must designate and identify one or more persons to be responsible for the overall supervision of each type of business the ETP Holder conducts.
- C. ETP Holders must maintain a record of the name and title of each person responsible for each specific business area, the persons whom they supervise and the dates the person assumed these responsibilities.
- D. ETP Holders must document the steps each supervising person takes to ensure compliance and how frequently the person is required to take such steps.
- E. ETP Holders must assign each associated person to a specific supervising person.
- F. ETP Holders must provide all associated persons with those portions of the written supervisory procedures that pertain to that person's job function. Each associated person must acknowledge in writing that he or she has received, has read, and will comply with the procedures, including revisions to the procedures.
- G. ETP Holders that employ automated systems as part of their supervisory system should describe them in their written supervisory procedures.

VI. SPECIAL SUPERVISORY CONCERNS

- A. ETP Holders have the same obligations to supervise associated persons commonly referred to as “independent contractors” as they do “employees.” Under certain circumstances, heightened supervision of independent contractors may be warranted.
- B. ETP Holders must establish and maintain a file of internal disciplinary actions taken against professional customers.
- C. ETP Holders must conduct an adequate investigation into the past activities of all new associated persons.
- D. ETP Holders must subject associated persons with a disciplinary history to heightened supervision.

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ETP Holders are reminded that the submission of written supervisory procedures to any regulatory department of the PCXE does not constitute their approval. The adequacy of written supervisory procedures will only be determined on an ongoing basis through the examination, surveillance and enforcement process. Questions regarding this Bulletin should be directed to Hassan Abedi, Manager, Enforcement, at (415) 393-5958; Frank Troutman, Director, Financial and Operational Compliance Department, at (415) 393-4135; John Chapin, Director, Equities Surveillance, at (312) 442-7790; Karen Hanson Wellman, Managing Director, Enforcement, at (415) 393-7949.