

MEMORANDUM

To: Members, Member Organizations, Participants and Participant Organizations

From: Joseph Cusick, Vice President Examinations & Investigations

**Re: Financial Accounting Standards Board (“FASB”) Statement No. 150 –
Reclassification of Certain Equity as Liabilities**

Date: June 16, 2004

This memorandum is intended to inform Philadelphia Stock Exchange (“Phlx” or the “Exchange”) Members, Member Organizations, Participants and Participant Organizations (collectively “Member Organizations”) about the requirements of FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity (“Statement 150”). Non-public broker-dealers registered with the Securities and Exchange Commission (“SEC”) are subject to Statement 150.

Overview of Statement 150 and Related Matters

A primary requirement of Statement 150 is the need to classify mandatorily redeemable financial instruments, generally defined as ownership interests in the issuing entity with mandatory redemption features, as liabilities.¹ Examples of these types of instruments are partnerships, limited liability companies and corporate capital accounts that are the subject of agreements that require the mandatory redemption of these accounts upon a certain event, such as the death of the owner of the capital.² Member Organizations that have agreements containing mandatory redemption clauses should evaluate the impact of Statement 150 and consider changing such agreements or altering the Member Organization’s capital structure to ensure adequate capitalization.

¹ For purposes of the Statement, “financial instruments” are essentially ownership interests in the issuing entity, which range from those that impose or could impose future obligations on the issuer to the benefit of the holder, to those that place the risk of the enterprise entirely on the holder (e.g., shares of common stock). “Mandatorily redeemable” means that the issuing entity will need to give cash, other assets, or other equity interests in the entity to the holder in exchange for the financial instruments upon the occurrence of an event certain to occur.

² Member Organizations need to consider all provisions of a redeemable instrument in determining whether the instrument is mandatorily redeemable. A term extension option—a provision that defers redemption until a specified liquidity level is reached—or a similar provision that may delay or accelerate the timing of a mandatory redemption does not affect the classification of a mandatorily redeemable financial instrument as a liability. In addition, in a subsequent FASB notice asserts that ownership interests that are required to be redeemed in accordance with a related agreement are to be viewed as mandatorily redeemable if the ownership interests are issued with the redemption agreement and the agreement addresses the redemption of the specific ownership interests. However, ownership interests that are redeemable only upon the liquidation or termination of the issuing entity continue to be classified as equity.

The FASB concluded that if an entity issues a financial instrument that requires, or may require, the issuing entity to transfer cash, assets, and/or shares of its stock to the holder of the instrument, and if the value or amount of the assets or shares are fixed upon the issuance of the instrument, or based on an index whose value is determined independently of, or inversely to, the successful operations of the entity, that entity must classify the instrument as a liability. The FASB believes that reclassification is necessary because the instrument imposes a cost on the issuing entity to the benefit of the instrument holder, and the holder's interest in the issuing entity is contrary to those of an owner (e.g., common shareholder) exposed solely to the potential benefits and risks derived from the operation of the business.

In response to a request from the Securities Industry Association (SIA), the SEC Division of Market Regulation concluded in a February 19, 2004, No-Action Letter that it "will not recommend enforcement action to the Commission if a broker-dealer that is a non-public entity, in calculating net capital under Securities Exchange Act Rule 15c3-1, adds to its regulatory net worth the carrying value of mandatorily redeemable financial instruments that Statement 150 excludes from the firm's GAAP equity." The No-Action Letter only provides relief from the net capital ramifications of the Statement's treatment of mandatorily redeemable financial instruments and does not extend to the accounting treatment of financial instruments (whether or not mandatorily redeemable) as set forth in Statement 150. (See Attachment for a copy of the No-Action Letter.) The temporary relief for a non-public broker-dealer to add to its regulatory net worth the carrying value of mandatorily redeemable financial instruments that would otherwise be excluded per Statement 150 extends only through the end of the first annual period beginning prior to December 15, 2004. Therefore Member Organizations operating within either calendar or fiscal years starting after December 15, 2004 will be fully subject to the requirements of Statement 150.

The No-Action Letter further requires that "a broker-dealer that wishes to take advantage of this relief must advise its designated examining authority ("DEA") of its intent." Consequently, to take advantage of the relief granted by the No-Action Letter, a Member Organization for which the Phlx is the DEA, must advise the Phlx Examinations Department of its intent to rely on the No-Action Letter by July 1, 2004.

Impact on Financial Reports

Therefore pursuant to Statement 150 Member Organizations must now reflect the recorded value of mandatorily redeemable ownership interests classified as liabilities in "Notes & Mortgages Payable: B Secured" of the statement of financial condition in the FOCUS Report (Line 24 of FOCUS Form II or Line 18 of FOCUS Form IIA). The value of those ownership interests that would be redeemed for cash should be included in aggregate indebtedness and reported in field 1211, and the value of interests redeemable for other assets or other equity interests should be included in field 1390, of either the Part II or IIA FOCUS filing. Those firms that choose to record an addition to net worth

in computing net capital should reflect the amount and description of the add-back as an allowable credit on line 4 B, field 3525 in the computation of net capital.

While this memorandum is intended to assist Member Organizations it should not be relied upon exclusively or used in place of any future or past regulations, laws, or interpretations set forth by the Exchange, the SEC, or FASB regarding this or related issues.

After reviewing Statement 150 and other relevant information on this matter Member Organizations are encouraged to contact Joe Cusick, at (215) 496-1576 for clarification and further assistance regarding these or other books and records requirements.