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**ANNUAL AUDITED REPORT  
FORM X-17A-5  
PART III**

**FACING PAGE  
Information Required of Brokers and Dealers Pursuant to Section 17 of the  
Securities Exchange Act of 1934 and Rule 17a-5 Thereunder**

REPORT FOR THE PERIOD BEGINNING 1/1/2010 AND ENDING 12/31/2010  
MM/DD/YY MM/DD/YY

**A. REGISTRANT IDENTIFICATION**

NAME OF BROKER-DEALER:

Potomac Capital Markets, LLC

OFFICIAL USE ONLY
FIRM ID. NO.

ADDRESS OF PRINCIPAL PLACE OF BUSINESS: (Do not use P.O. Box No.)

5 South Market Street, 4th Floor

(No. and Street)

Frederick Maryland 21701  
(City) (State) (Zip Code)

NAME AND TELEPHONE NUMBER OF PERSON TO CONTACT IN REGARD TO THIS REPORT

Christopher A. Weir (301) 695-9229  
(Area Code -- Telephone No.)

**B. ACCOUNTANT IDENTIFICATION**

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

Rothstein, Kass & Company, P.C.

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

4 Becker Farm Road Roseland NJ 07068  
(Address) (City) (State) (Zip Code)

**CHECK ONE:**

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

FOR OFFICIAL USE ONLY

\*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).

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OATH OR AFFIRMATION

I, Christopher A. Weir, swear (or affirm) that, to the best of my knowledge and belief the accompanying financial statement and supporting schedules pertaining to the firm of Potomac Capital Markets, LLC, as of December 31, 2010, 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:

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

*Christopher A. Weir*

Signature

*VP/CCO*

Title

*Uma M. Lee*  
Notary Public

My commission expires October 14, 2012

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 Proprietor's 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.
- (o) Independent auditor's report on internal accounting control.
- (p) Schedule of segregation requirements and funds in segregation--customers' regulated commodity futures account pursuant to Rule 171-5.

\*\*For conditions of confidential treatment of certain portions of this filing, see section 240.17a-5(e)(3).

**POTOMAC CAPITAL MARKETS, LLC**  
**STATEMENT OF FINANCIAL CONDITION**  
**AND**  
**INDEPENDENT AUDITORS' REPORT**  
**DECEMBER 31, 2010**

# POTOMAC CAPITAL MARKETS, LLC

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Certified  
Public  
Accountants

Rothstein, Kass & Company, P.C.  
4 Becker Farm Road  
Roseland, NJ 07068  
tel 973.994.6666  
fax 973.994.0337  
www.rkco.com

Beverly Hills  
Dallas  
Denver  
Grand Cayman  
Irvine  
New York  
Roseland  
San Francisco  
Walnut Creek

# Rothstein Kass

## INDEPENDENT AUDITORS' REPORT

To the Members of  
Potomac Capital Markets, LLC

We have audited the accompanying statement of financial condition of Potomac Capital Markets, LLC (the "Company") as of December 31, 2010. This statement of financial condition is the responsibility of the Company's management. Our responsibility is to express an opinion on this statement of financial condition based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also 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, as well as 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.

In our opinion, the statement of financial condition referred to above presents fairly, in all material respects, the financial position of Potomac Capital Markets, LLC, as of December 31, 2010, in conformity with accounting principles generally accepted in the United States of America.

*Rothstein, Kass & Company, P.C.*

Roseland, New Jersey  
February 23, 2011

# POTOMAC CAPITAL MARKETS, LLC

## STATEMENT OF FINANCIAL CONDITION

December 31, 2010

### ASSETS

Cash and cash equivalents	\$	15,474
Fees receivable		84,240
Due from parent		5,000
Investment in security, at fair value		7,119
Investment in partnership, at fair value		<u>14,228</u>
	\$	<u>126,061</u>

### LIABILITIES AND MEMBERS' EQUITY

Accounts payable and accrued expenses	\$	35,086
Members' equity		<u>90,975</u>
	\$	<u>126,061</u>

# POTOMAC CAPITAL MARKETS, LLC

## NOTES TO FINANCIAL STATEMENT

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### 1. Nature of business and summary of significant accounting policies

#### *Nature of Business*

Potomac Capital Markets, LLC (the "Company") is a Maryland Limited Liability Company ("LLC") organized and registered as a minimum net capital broker-dealer. The Company is a member of the Securities and Exchange Commission ("SEC") and is a member of the Financial Industry Regulatory Authority ("FINRA"). The business activities of the Company as prescribed in the membership agreement are limited to private placements of securities.

As a minimum net capital broker-dealer, the Company does not hold customer securities or cash balances.

#### *Basis of Presentation*

The financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America ("GAAP").

These financial statements were approved by management and available for issuance on February 23, 2011. Subsequent events have been evaluated through this date.

#### *Cash Equivalents*

The Company considers its investments in short-term money market accounts to be cash equivalents.

#### *Fees Receivable and Fee Revenue*

The Company carries its fees receivable at cost less an allowance for doubtful accounts. On a periodic basis, the Company evaluates its fees receivable and establishes an allowance for doubtful accounts, based on a history of past write-offs and collections and current credit conditions. At December 31, 2010 no allowance was deemed necessary.

Fee revenues are recorded in accordance with the terms of individual agreements and, where applicable, recognized on a pro rata basis over those terms.

#### *Valuation of Investments in Securities and Securities at Fair Value - Definition and Hierarchy*

In accordance with GAAP, fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (i.e., the "exit price") in an orderly transaction between market participants at the measurement date.

# POTOMAC CAPITAL MARKETS, LLC

## NOTES TO FINANCIAL STATEMENT

### 1. Summary of significant accounting policies (continued)

#### *Valuation of Investments in Securities at Fair Value - Definition and Hierarchy (continued)*

In determining fair value, the Company uses various valuation approaches. In accordance with GAAP, a fair value hierarchy for inputs is used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are those that market participants would use in pricing the asset or liability based on market data obtained from sources independent of the Company. Unobservable inputs reflect the Company's assumptions about the inputs market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. The fair value hierarchy is categorized into three levels based on the inputs as follows:

*Level 1* - Valuations based on unadjusted quoted prices in active markets for identical assets or liabilities that the Company has the ability to access. Valuation adjustments and block discounts are not applied to Level 1 securities. Since valuations are based on quoted prices that are readily and regularly available in an active market, valuation of these securities does not entail a significant degree of judgment.

*Level 2* - Valuations based on quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly.

*Level 3* - Valuations based on inputs that are unobservable and significant to the overall fair value measurement.

The availability of valuation techniques and observable inputs can vary from security to security and is affected by a wide variety of factors including, the type of security, whether the security is new and not yet established in the marketplace, and other characteristics particular to the transaction. To the extent that valuation is based on models or inputs that are less observable or unobservable in the market, the determination of fair value requires more judgment. Those estimated values do not necessarily represent the amounts that may be ultimately realized due to the occurrence of future circumstances that cannot be reasonably determined. Because of the inherent uncertainty of valuation, those estimated values may be materially higher or lower than the values that would have been used had a ready market for the securities existed. Accordingly, the degree of judgment exercised by the Company in determining fair value is greatest for securities categorized in Level 3. In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, for disclosure purposes, the level in the fair value hierarchy within which the fair value measurement in its entirety falls, is determined based on the lowest level input that is significant to the fair value measurement.

Fair value is a market-based measure considered from the perspective of a market participant rather than an entity-specific measure. Therefore, even when market assumptions are not readily available, the Company's own assumptions are set to reflect those that market participants would use in pricing the asset or liability at the measurement date. The Company uses prices and inputs that are current as of the measurement date, including periods of market dislocation. In periods of market dislocation, the observability of prices and inputs may be reduced for many securities. This condition could cause a security to be reclassified to a lower level within the fair value hierarchy.

# POTOMAC CAPITAL MARKETS, LLC

## NOTES TO FINANCIAL STATEMENT

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### 1. Summary of significant accounting policies (continued)

#### *Valuation Techniques*

#### Investments in Securities

The Company values investments in securities sold short that are freely tradable and are listed on a national securities exchange or reported on the NASDAQ national market at their last sales price as of the last business day of the year.

#### Investment in a Partnership

The Company values its investment in partnership by utilizing the net asset valuations provided by the underlying investment's administrators. Management considers rights, including any restrictions on the disposition of the interest in its determination of fair value. The investment in partnership is included in Level 3 of the fair value hierarchy. Unrealized gains on the investment in partnership are included in other income on the statement of operations.

#### *Income Taxes*

The Company is a limited liability company, and treated as a partnership for income tax reporting purposes. The Internal Revenue Code ("IRC") provides that any income or loss is passed through to the members for federal and state income tax purposes. Accordingly, the Company has not provided for federal or state income taxes.

At December 31, 2010, management has determined that the Company had no uncertain tax positions that would require financial statement recognition. This determination will always be subject to ongoing reevaluation as facts and circumstances may require. The Company remains subject to U.S. federal and state income tax audits for all periods subsequent to 2006.

#### *Use of Estimates*

The preparation of financial statements in conformity with GAAP requires the Company's management to make estimates and assumptions that affect the amounts disclosed in the financial statements. Actual results could differ from those estimates.

# POTOMAC CAPITAL MARKETS, LLC

## NOTES TO FINANCIAL STATEMENT

### 2. Fair value measurements

The Company's assets recorded at fair value have been categorized based upon a fair value hierarchy as described in the Company's significant accounting policies in Note 1.

The following table presents information about the Company's assets measured at fair value as of December 31, 2010:

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance as of December 31, 2010
<b>Assets</b>				
Investment in security, at fair value	\$ 7,119	\$ -	\$ -	\$ 7,119
Investment in partnership, at fair value	-		14,228	14,228
	<u>\$ 7,119</u>	<u>\$ -</u>	<u>\$ 14,228</u>	<u>\$ 21,347</u>

The following table presents additional information about Level 3 assets measured at fair value. Both observable and unobservable inputs may be used to determine the fair value of positions that the Company has classified within the Level 3 category. As a result, the unrealized gains and losses for assets within the Level 3 category may include changes in fair value that were attributable to both observable (e.g., changes in market interest rates) and unobservable (e.g., changes in unobservable long-dated volatilities) inputs.

Changes in Level 3 assets measured at fair value for the year ended December 31, 2010 were as follows:

	Beginning Balance January 1, 2010	Realized & Unrealized Gains (Losses)	Purchases, Sales and Settlements	Net Transfers In and/or (Out) of	Ending Balance December 31, 2010	Unrealized Gains (Losses) for Investments still held at December 31, 2010
<b>Asset (at fair value)</b>						
Investment in partnership, at fair value	\$ 14,228	\$ -	\$ -	\$ -	\$ 14,228	\$ -

# POTOMAC CAPITAL MARKETS, LLC

## NOTES TO FINANCIAL STATEMENT

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### 3. Net capital requirement

The Company is a member of the FINRA and is subject to the SEC Uniform Net Capital Rule 15c3-1. This Rule requires the maintenance of minimum net capital and that the ratio of aggregate indebtedness to net capital, both as defined, shall not exceed 15 to 1, and that equity capital may not be withdrawn or cash dividends paid if the resulting net capital ratio would exceed 10 to 1. At December 31, 2010, the Company's net capital was approximately \$21,000, which was approximately \$16,000 in excess of its minimum requirement of approximately \$5,000.

### 4. Exemption from Rule 15c3-3

The Company is exempt from the SEC Rule 15c3-3 pursuant to the exemptive provision under sub-paragraph (k)(2)(i) and, therefore, is not required to maintain a "Special Reserve Bank Account for the Exclusive Benefit of Customers".

### 5. Related party transactions and commitments

#### *Service Agreement*

The Company is 99% owned by Potomac Investment Services, Inc., ("PIS") a Maryland C corporation. PIS provided employee, office space, communication systems, and administrative services in the amount of \$356,000 for the year ended December 31, 2010. There are no individuals which are employed directly by the Company. These services were provided under an Administration Services Agreement that provides for minimum charges for basic services and additional charges when additional services are provided; the agreement has a term of five years from March 2003 is renewable annually, and is cancelable with 30 days notice by either party at the end of the initial term.

#### *Due from Parent*

Amounts due from parent represent non-interest bearing advances from the Company to PIS which have no specific repayment terms or due dates. These amounts may be used to offset future expenses incurred under the Administration Services Agreement.

### 6. Concentrations of credit risk

The Company maintains its cash balances in various financial institutions, which at times, may exceed federally insured limits (\$250,000 per depositor). The Company has not experienced any losses in such accounts and believes it is not subject to any significant credit risk on cash.

### 7. Concentration of revenue

Fees earned from two customers accounted for approximately 96% of total fees in 2010. At December 31, 2010, the receivable balance due from these customers was approximately \$84,000.