(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

Written comments were neither solicited nor received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

A. By order approve such proposed rule change, or

B. Institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

• Use the Commission's Internet comment form (*http://www.sec.gov/rules/sro.shtml*); or

• Send an e-mail to *rule-comments@sec.gov.* Please include File Number SR–NASD–2004–078 on the subject line.

Paper Comments:

• Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609.

All submissions should refer to File No. SR–NASD–2004–078. This file number should be included on the subject line if e-mail is used. To help us process and review comments more efficiently, comments should be sent in hardcopy or by e-mail but not by both methods. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/sro.shtml*). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of NASD. All submissions should refer to file number SR–NASD–2004–078 and should be submitted by July 14, 2004.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[6]

J. Lynn Taylor,

Assistant Secretary.

[FR Doc. 04–14235 Filed 6–22–04; 8:45 am]

BILLING CODE 8010–01–P

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–49882; File No. SR–NYSE–2002–36]

Self-Regulatory Organizations; Order Approving Proposed Rule Change and Amendments No. 1, 2, and 3 by New York Stock Exchange, Inc. Relating to Internal Controls and Supervisory Control Amendments and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 4

June 17, 2004.

I. Introduction

On August 16, 2002, the New York Stock Exchange, Inc. (''NYSE'' or ''Exchange'') filed with the Securities and Exchange Commission (''SEC'' or ''Commission''), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'')[1] and Rule 19b–4 thereunder,[2] a proposed rule change relating to the establishment, maintenance, and testing of internal controls and supervision of NYSE members. The NYSE submitted Amendment No. 1 to the proposed rule change on November 20, 2002.[3] The proposed rule change, as amended, was published for comment in the **Federal Register** on November 27, 2002.[4] The Commission received five comment letters in response to proposed rule change.[5] In response, on April 28, 2003, the NYSE filed Amendment No. 2 to the proposed rule change.[6] On August 7, 2003, the NYSE submitted Amendment No. 3 to the proposed rule change.[7] On August 13, 2003, the Commission published Amendments No. 2 and 3 for comment in **Federal Register**.[8] The Commission received four comment letters in response to these Amendments.[9] These comment letters and the NYSE's response in Amendment No. 4,[10] submitted on April 16, 2004, are summarized below. This Order approves the proposed rule, as

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[6] 17 CFR 200.30–3(a)(12).

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] *See* letter from Darla Stuckey, Corporate Secretary, NYSE, to Nancy Sanow, Assistant Director, Division of Market Regulation (''Division''), Commission, dated November 18, 2002 (''Amendment No. 1''). In Amendment No. 1, the NYSE added ''customer changes of investment objectives'' to the list of enumerated activities with regard to which Exchange members must maintain written policies and procedures.

[4] *See* Securities Exchange Act Release No. 46858 (November 20, 2002), 67 FR 70994. On December 18, 2002, the Commission extended the 21-day comment period for an additional 30 days. *See* Securities Exchange Act Release No. 47021, 67 FR 78840 (December 26, 2002).

[5] *See* letters from Arthur F. Grant, President, Cadaret, Grant & Co., Inc., to Jonathan G. Katz, Secretary, Commission, dated December 17, 2002 (''Cadaret Grant Letter''); Christopher R. Franke, Chairman, Self-Regulation and Supervisory Practices Committee, Securities Industry Association, to Jonathan G. Katz, Secretary, Commission, dated December 18, 2002 (''Franke SIA Letter''); Kimberly H. Chamberlain, Vice President and Counsel, State Government Affairs, Securities Industry Association, to Secretary, Commission, dated December 23, 2002 (''Chamberlain SIA Letter''); Brian C. Underwood, Senior Vice President and Director of Compliance, A.G. Edwards & Sons, Inc., to Jonathan G. Katz, Secretary, Commission, dated December 18, 2002 (''A.G. Edwards Letter''); and Selwyn J. Notelovitz, Senior Vice President, Global Compliance, Charles Schwab & Co., Inc., to Jonathan G. Katz, Secretary, Commission, dated February 25, 2003 (''Schwab Letter'').

[6] *See* letter from Darla Stuckey, Corporate Secretary, NYSE, to Nancy Sanow, Assistant Director, Division, Commission, dated April 25, 2003 (''Amendment No. 2''). In Amendment No. 2, the Exchange submitted a response to comments that it had received in response to the Original Notice. In addition, the Exchange amended portions of the proposed rule text to address certain of the commenters' concerns.

[7] *See* letter from Darla Stuckey, Corporate Secretary, NYSE, to Nancy Sanow, Assistant Director, Division, Commission, dated August 6, 2003 (''Amendment No. 3''). Amendment No. 3, which replaced and superceded Amendment No. 2 in its entirety, responded to certain concerns the Commission raised with the NYSE following the Exchange's submission of Amendment No. 2.

[8] *See* Securities Exchange Act Release No. 48299 (August 7, 2003), 68 FR 48431. On September 8, 2003, the Commission extended the 21-day comment period for an additional 30 days. *See* Securities Exchange Act Release No. 48460, 68 FR 54034 (September 15, 2003).

[9] *See* letters from Pamela K. Cavness, Director of Compliance, Edward Jones, to Jonathan G. Katz, Secretary, Commission, dated October 2, 2003 (''Edward Jones Letter''); Barbara Black, Director, Pace University Investor Rights Project, to Secretary, Commission, dated October 2, 2003 (''Pace Letter''); John Polanin Jr., Chairman, Self-Regulation and Supervisory Practices Committee, SIA, dated October 3, 2003 (''Polanin SIA Letter''); and Ralph A. Lambiase, President, North American Securities Administrators Association, and Director, Connecticut Division of Securities, dated October 24, 2003 (''NASAA Letter'').

[10] *See* letter from Darla Stuckey, Corporate Secretary, NYSE, to Nancy Sanow, Assistant Director, Division, Commission, dated April 15, 2004 (''Amendment No. 4''). Amendment No. 4, in response to comments, altered NYSE Rules 342.42, 408.11 and the Interpretation of Rule 342(a)(b)/03.

amended, and accelerates approval of Amendment No. 4.

II. Description

A. Background

1. Purpose for and General Description of Proposal

The NYSE's proposed rule change is designed to address concerns regarding its members' supervisory systems. Many of these concerns were brought to light following an investigation by the Commission into the activities of a branch office manager, Frank Gruttadauria.[11] Over a period of 15 years, Mr. Gruttadauria misappropriated over $100 million from more than 40 clients. Mr. Gruttadauria was able to cover up his fraud by, among other things, providing clients with falsified account statements and by causing the actual brokerage statements for some clients to be mailed, without the knowledge or authorization of these clients, to entities or post office boxes under his control.

In an effort to ensure that members are more effectively supervised going forward, the NYSE has proposed amendments to existing rules to strengthen members' supervisory procedures and internal controls. Proposed amendments to NYSE Rules 342.19, 342.23, 401 and 410 set forth general and specific supervisory control requirements. Amendments to NYSE Rule 342(a)(b)/03 of the Exchange Interpretation Handbook set forth the subjects that an annual inspection must address when evaluating the internal controls present in a particular branch office. In addition, the NYSE proposes to amend Exchange Rule 408 to limit the duration of a member's authority to exercise time and price discretion pursuant to a non-written customer request.

2. General Comments on the Proposed Rule Change

Many commenters urged greater flexibility in the general implementation of the proposed rule changes. For example, two commenters suggested that the proposed rule amendments should be adopted in the form of ''principles for effective supervision'' or ''best practices.'' [12] Most commenters recommended that the NYSE adopt more flexible rules to account for the varied member organization business models.[13] Commenters suggested that the proposed amendments would not be economically feasible for all types of firms.[14] One commenter suggested that the Gruttadauria case was not so much a failure of the current regulatory system, including member firms' internal controls and supervisory practices, as it was the result of a single individual intent on defrauding his customers.[15]

The NYSE responded that it believed the authority carried by changes to Exchange rules and their interpretations was necessary to effectively induce appropriate conduct in this area. The Exchange, however, as discussed in greater detail below, agreed that greater flexibility would address the varied business organization models that its membership represents and provided certain changes to its proposed rules to account for such variation.

B. Independent Supervision of Managers' Activity

1. Original Proposal and Comments Received

NYSE Rule 342.19, as originally proposed, would require that members develop written policies and procedures reasonably designed to independently review and supervise the customer account activity of Sales Managers, Regional/District Sales Managers, Branch Office Managers, or any person performing a similar supervisory function (collectively, ''Producing Managers''). Some commenters sought clarification of the ''independent supervision'' standard.[16] The same commenters suggested that individuals within a firm at equal or higher organizational levels, peripherally involved, or who receive an indirect benefit from the activity being reviewed may, nevertheless, have sufficient independence to supervise Managers.[17]

In Amendment No. 2, the NYSE proposed amendments to its Rule 342.19 to clarify that reviews of Producing Managers' customer account activity may be conducted by a ''qualified person,'' provided such person is senior to the manager (*i.e.*, not any person with the same job function as the manager or any person subordinate to the manager). The proposed rule has also been revised to make clear that the ''qualified person'' standard, in the context of NYSE Rule 342.19, is defined by NYSE Rule 342.13, which, among other things, requires a creditable three-year record as a registered representative or equivalent experience and passing specified supervisory qualification examinations administered by the NASD and acceptable to the NYSE, such as the Series 9/10 or the Series 24 exams.

One commenter suggested, in response to Amendments No. 2 and 3, that the Rule allow for review by ''sufficiently independent'' persons ''at equal levels of seniority,'' such as administrative managers who are ''outside the * * * manager's reporting line'' and, thus, able to act ''without fear of reprisal'' by the Producing Manager.[18] The NYSE responded that customer account activity of Producing Managers is a serious and sensitive regulatory area. Nevertheless, while the Exchange takes the position that there are advantages when a Producing Manager's activity is reviewed by a person senior to that Manager, the Exchange recognizes that such arrangements might not be practical for very small firms. Further, the Exchange agrees that establishing an alternative ''independence'' standard for those supervisory persons designated to review a Producing Managers' customer activity is a reasonable and effective means to provide administrative flexibility.

2. Current Proposal

Thus, in Amendment No. 4 to proposed NYSE Rule 342.19(a), the Exchange proposes to permit supervisory reviews to be conducted by a qualified person who is either senior to or ''otherwise independent'' of the Producing Manager under review. NYSE proposes to define an ''otherwise independent'' person as one who does not report either directly or indirectly to the Producing Manager under review, is not in the same office as the Producing Manager, does not otherwise have supervisory responsibility over the activity being reviewed, and alternates review of the Producing Manager with another qualified person at least every two years.

In addition, the NYSE is proposing to require that ''alternate'' independent supervision of a Producing Manager by another qualified person be established if the person designated to review a Producing Manager receives an override or other income derived from that Producing Manager's customer activity

[11] *See In the Matter of SG Cowen Securities Corporation,* 80 SEC Docket 3154 (September 9, 2003), Securities Exchange Act Release No. 48335 (August 14, 2003) Administrative Proceeding File No. 3–11216. *See also In the Matter of Lehman Brothers, Inc.,* 80 SEC Docket 3173 (September 9, 2003), Securities Exchange Act Release No. 48336 (August 14, 2003) Administrative Proceeding File No. 3–11217.

[12] *See* Franke SIA Letter and A.G. Edwards Letter.

[13] *See* Franke SIA Letter; A.G. Edwards Letter, Cadaret Letter, and Schwab Letter.

[14] *See* Cadaret Letter, Franke SIA Letter, and A.G. Edwards Letter.

[15] *See* Franke SIA Letter.

[16] *See* Franke SIA Letter; A.G. Edwards; and Schwab Letter.

[17] *Id.*

[18] *See* Polanin SIA Letter.

that represents more than 10% of the designated person's gross income derived from the member over the course of a rolling 12-month period.

Finally, in Amendment No. 4 to Exchange Rule 342.19(b), NYSE proposes an exception for members so limited in size and resources that there is no qualified person senior to, or otherwise independent of, the Producing Manager to conduct the review. In such a situation, the NYSE proposes to allow another person who is a ''qualified person,'' but not senior to or otherwise independent of the Producing Manager, to conduct the review in compliance with the Rule's independence provisions to the extent practicable. As provided in proposed Exchange Rule 342.19(c), if a member needs to rely on the exception in NYSE Rule 342.19(b), the member must document all the factors used to determine why complete compliance with the Rule is not possible and that the procedures in place comply with the Rule to the extent practicable.[19]

C. Internal Controls

1. Original Proposal and Comments Received

Proposed NYSE Rule 342.23 requires members and member organizations to develop and maintain adequate internal controls over each of their business activities. The proposed rule further requires that such controls provide for the establishment of procedures for independent verification and testing of those business activities. Some commenters sought clarification as to who would be sufficiently ''independent'' to perform these verification and testing functions.[20] While the commenters acknowledged that supervisors lack sufficient independence to verify and test procedures they personally implement, they nonetheless seek regulatory flexibility to accommodate a variety of supervisory structures beyond self-supervision.[21] Commenters contended that senior supervisors in a hierarchal supervisory structure should not be excluded simply because they may derive an indirect benefit from the activity under review.[22]

In response, the Exchange stated that it recognized the far-ranging scope and variety of activities subject to the verification and testing requirements. In Amendment No. 2, the Exchange deleted the requirement that internal control procedures be ''separate and apart from the day-to-day supervision of such functions'' from the proposed amendments to NYSE Rule 342.23 to allow greater flexibility in establishing such internal controls. However, the Exchange stated that firms would be expected to make an informed determination that persons responsible for verification and testing of business activities are sufficiently independent and qualified to do so effectively.

Commenters also sought clarification and assurance that the proposed requirements would not create an obligation for firms to annually test and verify ''every aspect'' of their supervisory procedures, but rather allow for a ''risk-based approach'' based upon ongoing assessments of the firm's business.[23] In Amendment No. 2, the NYSE proposed to revise NYSE Rule 342.23 to allow for an ongoing analysis, based upon appropriate criteria, to assess and prioritize those business activities requiring independent verification and testing.

One commenter recommended that the ''NASD CEO Certification Rule'' be applicable to NYSE firms.[24] The NYSE noted that the NASD did not address the issue of CEO certification in the context of its corresponding proposed rule change addressing internal and supervisory controls.[25] Accordingly, the NYSE will evaluate the appropriateness of a comparable requirement separate and apart from the instant filing.

2. Current Proposal

As amended in response to comments, proposed NYSE Rule 342.23 would require that a member or member organization develop and maintain adequate controls over each of its business activities, including ones that provide for the establishment of procedures for independent verification and testing of those business activities. The member may employ an ongoing analysis, based upon appropriate criteria, to assess and prioritize those business activities that require independent verification and testing at a given time. The member must include a summary of its efforts, including a summary of the tests conducted and significant exceptions identified, in the Annual Report that it submits to its chief executive officer or managing partner, pursuant to Exchange Rule 342.30. In addition, the proposed rule provides an exemption from the independent verification and testing procedures for those members that do not conduct a public business, have a capital requirement of $5,000 or less, or that employ ten or fewer registered representatives. The proposed rule also cross references proposed Exchange Rule 401(b), which would establish certain categories of activities for which members are required to maintain written policies and procedures administered pursuant to proposed NYSE Rule 342.23.

D. Annual Branch Office Inspections

1. Original Proposal and Comments Received

The NYSE originally proposed to amend Rule 342(a)(b)/03 in the NYSE Interpretation Handbook to require that annual branch office inspections be conducted by a person who is ''independent'' of the direct supervision or control of the branch office, including Branch Office Manager, Sales Managers, District/Regional Managers assigned to the office, or any other person performing a similar supervisory function.

One commenter suggested that imposing this amendment would be economically burdensome to firms, possibly leading firms to hire supervisors or outsource the inspection function at significant cost to the firm.[26] In addition, commenters sought clarification as to who would be sufficiently independent to conduct the annual inspections.[27] Commenters suggested that supervisors, who are part of the direct supervision or control of the branch office and are the most familiar with registered representatives and activities located at particular offices, are in the best position to review the activities of a branch office, identify weaknesses, and take corrective action.[28] One commenter noted that the size and structure of some firms may mean that no individual within the firm could be considered ''independent.''[29] Some commenters suggested that scenarios involving inspection by supervisory personnel in a hierarchical supervisory system may be sufficiently outside the day-to-day chain of command to meet the ''independence''

[19] For example, the review of a Producing Manager may not be conducted by a qualified non-senior person in the Producing Manager's office if a qualified senior, or otherwise independent, person is available in another office of the member organization.

[20] *See* Franke SIA Letter; Schwab Letter; and A.G. Edwards Letter.

[21] *Id.*

[22] *See* Franke SIA Letter; and Schwab Letter.

[23] *See* Franke SIA Letter; and A.G. Edwards Letter.

[24] *See* NASAA Letter.

[25] *See* Exchange Act Release No. 48298 (August 7, 2003), 68 FR 48421 (August 13, 2003) (SR–NASD–2002–162) (notice of filing of Amendment Nos. 1 and 2 by the NASD relating to supervisory control amendments).

[26] *See* Pace Letter.

[27] *See* Franke SIA Letter; Schwab Letter; and A.G. Edwards Letter.

[28] *See* Schwab Letter, and Franke SIA Letter.

[29] *See* Franke SIA Letter.

standard.[30] Another commenter suggested that firms should have the flexibility to design internal control systems that conform to the nature of the business conducted by the member.[31] In addition, a commenter asserted that business line supervisors' auditing of branch and satellite offices serves to reinforce their accountability for the registered representatives' actions.[32]

In response to the commenters' concerns, the NYSE stated its belief that in order for a branch inspection program to be effective, it needs to include reasonable guidelines to minimize conflicts of interest. The Exchange also suggested that such guidelines should not exclude all participants at every level of a branch office's hierarchal supervisory structure, but that it was reasonable to exclude the branch manager and any person to whom the branch manager directly reports.

Accordingly, in Amendment Nos. 2 and 3, the NYSE amended Rule 342(a)(b)/03 in the NYSE Interpretation Handbook to delete the characterization of Sales Managers, District/Regional Managers assigned to an office, or any other person performing similar supervisory function as individuals not independent of the direct supervision or control of the branch office, but retained the characterization of Branch Office Managers as not being independent. The Exchange also added persons who report to a Branch Office Manager, and any person to whom such manager directly reports, to the list of people who are deemed not ''independent'' for the purposes of NYSE Rule 342(a)(b)/03 in the Exchange Interpretation Handbook.

Commenters raised the concern that the proposed amendments, in conjunction with a pending NYSE rule proposal [33] to amend the definition of ''branch office,'' would increase the burden with respect to annual inspections for firms with far-reaching branch networks.[34] The Exchange currently requires, absent a specific waiver, annual inspections of each branch office location.[35] The Exchange responded that pending NYSE Rule amendments relating to the definition of a ''branch office'' would significantly reduce the types of locations required to be registered as branch offices. Accordingly, the NYSE believes that the number of branch office inspections required of each member organization would be reduced. NASAA also requested clarification that a person conducting a branch office inspection cannot be a person who directly *or indirectly* reports to the sales manager of the office.[36] The NYSE agreed and is adding this clarification to the Interpretation of the Rule in Amendment No. 4. The NYSE represents that the wording ''any person who reports to such Manager'' is intended to be broadly construed to encompass all persons who report, directly or indirectly, to a Manager.

Finally, NASAA suggests requiring all branch office inspection reports be sent to the member organization's compliance department directly and then delivered to the branch office.[37] The Exchange does not intend to amend the proposed rule in this regard as it believes that each member organization should address to whom within the firm an inspection report must be sent in its policy and procedures manual.

2. Current Proposal

Thus, the NYSE proposes to amend Rule 342(a)(b)/03 in the NYSE Interpretation Handbook to require that the branch office inspections that are to be conducted at least annually be conducted by a person who is ''independent'' of the direct supervision or control of the branch office, including the Branch Office Manager, any person who reports directly or indirectly to such Manager, or any person to whom such Manager directly reports. Accordingly, the Exchange is amending Rule 342(a)(b)/03 in the NYSE Interpretation Handbook to clarify that the person conducting the inspection may not be someone that directly or indirectly reports to a Manager. The NYSE proposes that members conduct inspections at least annually, absent a demonstration to the satisfaction of the Exchange that because of proximity, special reporting or supervisory practice, other arrangements may satisfy the supervisory requirements provided for in the NYSE Rule 342. The proposed rule change, as amended, also provides that a written authorization by the Exchange of an alternative arrangement to the annual inspections would suffice for recordkeeping purposes.

In addition, the NYSE proposes to require that office inspections include, without limitation, the testing and independent verification of the member's internal controls in the areas of: Safeguarding customer funds and securities; maintaining books and records; supervision of customer accounts serviced by branch office managers; transmittal of funds between customers and registered representatives and between customers and third parties; validation of customer address changes; and validation of changes in customer account information.

E. Written Policies and Procedures for Certain Customer Activities

1. Original Proposal and Comments Received

Proposed NYSE Rule 401(b) requires each member and member organization to maintain written policies and procedures, administered pursuant to the internal control requirements prescribed under proposed NYSE Rule 343.23, that specifically address transmittals of customer funds or securities between accounts, changes in investment objectives, and changes of address. These designated policies and procedures must include a method of customer confirmation, notification, or follow-up that can be documented.

One commenter requested that these requirements apply only to retail accounts.[38] An ''institutional carve-out'' was sought on the grounds that much institutional business is done ''delivery versus payment,'' ''receipt versus payment,'' or through prime brokerage accounts. Another commenter suggested that, since institutional trading processes, systems, and controls are so distinct from retail account servicing, the proposed Rule 401 requirements should apply to retail activity but have ''limited, if any, application to institutional business.'' [39]

The Exchange believes that an exemption for institutional accounts is inappropriate, notwithstanding the concerns raised in the comment letters. The NYSE states that in order for an internal controls policy to be effective, it must be comprehensive. Accordingly, the Exchange believes that it is reasonable and appropriate that regulatory oversight in the sensitive areas designated in proposed NYSE Rule 401(b) should extend to institutional account activity.

[30] *See* Franke SIA Letter; and A.G. Edwards Letter.

[31] *See* Schwab Letter.

[32] *Id.*

[33] The NYSE submitted a proposed rule change amending the definition of ''branch office' to include, with certain limited exceptions, any location, other than a main office, where one or more associated persons of a member organization regularly conduct the business of effecting any transactions in or inducing or attempting to induce the purchase or sale of any security, or is held out as such. *See* Securities Exchange Act Release No. 46888 (November 22, 2002), 67 FR 72257 (December 4, 2002) (SR–NYSE–2002–34).

[34] *See* A.G. Edwards Letter, Franke SIA Letter and Chamberlain SIA Letter.

[35] *See* Rule 342(a)(b)/03 in the NYSE Interpretation Handbook.

[36] *See* NASAA Letter.

[37] *Id.*

[38] *See* Franke SIA Letter.

[39] *See* Polanin SIA Letter.

2. Current Proposal

Thus, the proposed amendments to NYSE Rule 401 would require members and member organizations to maintain written policies and procedures, administered pursuant to the internal control requirements prescribed under NYSE Rule 342.23, specifically with respect to transmittals of customer funds or securities, customer changes of address, and customer changes of investment objective. The policies and procedures must include a means/method of customer confirmation, notification, or follow-up that can be documented.

F. Discretionary Accounts

1. Original Proposal and Comments Received

As originally proposed, changes to existing NYSE Rule 408(d) provided that a member retains time and price discretion on behalf of its customer until the end of the day on which the order was given to the member, absent written authorization to the contrary. Several commenters suggested that the one-day time and price discretionary authority should be limited only to retail accounts and that NYSE should craft an exemption for institutional accounts.[40] Commenters argued that large orders for institutional accounts are ''worked'' over more than a day on a good-till-cancelled/not-held basis.

NYSE responded that it believes that a general institutional exemption is inappropriate. However, the Exchange responded to the comments by revising its Rule to provide that written authorization need not be obtained for the exercise of time and price discretion beyond the day a customer grants such discretion, for orders handled by floor brokers pursuant to valid good-till-cancelled instructions issued on a ''not held'' basis.

One commenter requested that NYSE clarify that the requirement to obtain written instructions for the exercise of time and price discretion beyond the business day it was granted allows customers to issue general ''standing'' instructions, rather than issuing written instructions on an order-by-order basis.[41] The NYSE responded that Exchange Rule 408(d) clearly limits the exercise of time and price discretion to a single transaction and that customers may grant more extensive discretionary authority by executing a trading authorization with their registered representative. Another commenter noted that by limiting the institutional exemption to ''floor broker'' orders, the NYSE may inappropriately be its own market, and creating a regulatory disincentive for firms to access other marketplaces.[42] In response, the Exchange stated in Amendment No. 4 that it agreed the institutional exemption need not apply solely to NYSE floor brokers.

2. Current Proposal

Accordingly, the NYSE proposes to amend NYSE Rule 408(d) so that the limitation would not apply to time and price discretion exercised in an ''institutional account'' pursuant to valid good-till-cancelled instructions issued on a not-held basis and to remove the limitation of the exemption to situations where ''floor brokers'' exercise such price and time discretion. The Exchange also proposes to require that any exercise of time and price discretion be reflected on the order ticket. This would provide an exception to the general rule that restricts a broker's authority to exercise time and price discretion until the end of the business day on which the customer granted such discretion, absent a specific, written contrary indication signed and dated by the customer.

In Amendment No. 4, the Exchange proposes to define an ''institutional account'' to mean ''the account of (i) a bank (as defined in Section 3(a)(6) of the Securities Exchange Act of 1934), (ii) a savings association (as defined in Section 3(b) of the Federal Deposit Insurance Act), the deposits of which are insured by the Federal Deposit Insurance Corporation, (iii) an insurance company (as defined in Section 2(a)(17) of the Investment Company Act of 1940), (iv) an investment company registered with the Securities Exchange Commission under the Investment Company Act of 1940, (v) a state or a political subdivision thereof, (vi) a pension or profit sharing plan, subject to ERISA, with more than $25,000,000 total assets under management, or of an agency of the United States or of a political subdivision thereof, (vii) any person that has a net worth of at least forty-five million dollars and financial assets of at least forty million dollars, or (viii) an investment adviser registered under Section 203 of the Investment Advisers Act of 1940.''

One commenter suggests a means of communicating this time and price discretion restriction to clients to create ''an additional safeguard against potential abuse,'' since client awareness of the restriction would allow them to ''check the behavior of member associates.''[43] The NYSE responded that, as a practical matter, brokers will need to inform clients who grant time and price discretionary authority that a ''same-day'' restriction is in effect with respect to that authority. The Exchange believes that the Information Memorandum to be issued in conjunction with an approval of the proposals will remind registered representatives and firms of their obligations in this regard.

G. Maintenance of ''Account Designation Change'' Documentation

1. Original Proposal and Comments Received

The proposed amendments to NYSE Rule 410 would enhance the recordkeeping requirements for orders that members receive. Currently, Exchange Rule 410 requires members and member organizations to preserve a record of certain information about every order transmitted or carried to the floor of the Exchange and prescribes procedures for administering changes in account name or designation.

In addition to certain technical changes, the original proposed amendments to NYSE Rule 410 would expand the application of the Rule to orders sent to all marketplaces, not just the floor of the Exchange. The original proposal also would require that any person who approves account name or designation changes be qualified by passing an examination acceptable to the Exchange, such as the NASD Series 9/10 or the Series 14. In addition, the original proposed rule change would clarify that the Rule applies to all account name and designation changes, including related accounts and error accounts. Furthermore, the proposal would require written documentation of the essential facts relied upon when approving an account name or designation change and that such documentation is to be maintained in a ''central location.'' One commenter sought clarification that such documentation be maintained ''in a location where the determination and approval occurs, not in the Home Office'' so as to avoid a ''duplicate record.''[44]

The Exchange responded that it believes that the determination of where such documentation should be retained would depend on the supervisory structure of the firm. Typically, the ''central location'' would be where the account name or designation change

[40] *See* A.G. Edwards Letter, Schwab Letter, and Franke SIA Letter.

[41] *See* Franke SIA Letter.

[42] *See* Polanin SIA Letter.

[43] *See* Pace Letter.

[44] *See* A.G. Edwards Letter.

was approved. However, the NYSE believes that the proposed rule amendments should not be construed to be determinative of precisely where such records should be maintained, nor discourage maintenance of records in more than one location if regulatory purposes are well served by doing so.

2. Current Proposal

In response to the comment, the Exchange has proposed to delete the requirement that relevant documentation be maintained in ''a central location'' and to replace the phrase with the requirement that such documentation be maintained for three years, the first two in an ''easily accessible place,'' consistent with the meaning of that term in Rule 17a–4 under the Act.[45] The remainder of the current proposal to amend NYSE Rule 410 remains the same as the original proposal.

H. Effective Date

Commenters expressed concern that the effective date of any new requirements allow adequate time to enable firms to make necessary systems changes in an efficient and cost-effective manner.[46] Accordingly, the Exchange intends to establish an effective date six months from Commission approval of the proposed rule change, as amended, to allow members and member organizations sufficient time to address any necessary procedural or systems changes.

III. Discussion

After careful review, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.[47] In particular, the Commission finds that the proposal, as amended, is consistent with the provisions of section 6(b)(5) of the Act,[48] which requires, among other things, that a national securities exchange's rules be designed, to prevent fraud and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and to perfect the mechanism of a free and open market and a national market system and, in general, to protect investors and the public interest. The Commission finds that the NYSE proposal, as amended, is designed to accomplish these ends by requiring members to monitor certain conduct of employees that handle customer accounts, to establish more extensive supervisory and internal control procedures for customer accounts, and to enhance the annual inspection requirements that members undertake. The Commission also believes that the proposed rule change, as amended, may reduce the potential for customer fraud and theft of customers' identities and funds.

A. Independent Supervision of Producing Managers' Activity

Proposed Exchange Rule 342.19 is designed to provide for the independent supervision of the customer account activity that is effected by Producing Managers. In response to commenters' requests for clarity as to who would be considered ''independent'' of a Producing Manager for purposes of performing the supervisory reviews, the NYSE specified in Amendment No. 3 that someone ''qualified'' as a supervisor pursuant to NYSE Rule 342.13[49] that is senior to the Producing Manager under review would be sufficiently independent of the Producing Manager. In response to comments to proposed NYSE Rule 342.19 that advocated non-senior, but independent peer managers to be able to conduct supervisory reviews, the NYSE adopted a more flexible approach where a person who is senior or ''otherwise independent'' of the Producing Manager could conduct the review of the Manager. The Exchange also provided that if the senior or otherwise independent person received more than 10% of his or her gross income from the Producing Manager under review through overrides or other income derived from the Producing Manager's customer activity, the member must provide that an alternate independent qualified person supervise the Producing Manager. In addition, the Exchange established an exception for firms that, by reason of limitations in size and/or resources, could not provide a supervisor who is ''senior to or otherwise independent of'' the Producing Manager or a supervisor that receives 10% or less of his or her income as commission overrides from the Producing Manager (*e.g.*, if the firm has only one office, or an insufficient number of qualified personnel who can conduct reviews on a two-year rotation).[50] If a firm relies on this exception, it must document the factors used to determine that complete compliance is not possible, and in any event it must comply with the senior or otherwise independent standard to the extent practicable.[51] The Commission expects the NYSE to carefully monitor member compliance with the requirements for invoking this exception.

The Commission believes that the supervision of managers is an important component to an effective internal control system that seeks to monitor the business activity of a member. Because managers often conduct the day-to-day supervision of their branch, division, or region, the Commission believes that it is important that they are themselves monitored for their dealings with customer accounts. The Commission believes that a ''qualified'' supervisor under NYSE Rule 342.13—such as a person registered as a Sales Supervisor (NASD Series 9/10) or Principal (NASD Series 24)—possesses a sufficiently high level of expertise to understand the issues that arise during the reviews. Moreover, the Commission believes that Exchange's requirement that the supervisor be ''senior to or otherwise independent of'' the Producing Manager, and the standards proposed to define ''otherwise independent,'' should diminish the likelihood that the supervisory review would be conducted less than vigorously because of the self-interest of the reviewer. In addition, the Commission believes that the NYSE's proposed documentation requirement, for members desiring to rely on the ''small firm'' exception, should encourage members to attempt earnestly to comply with the requirement that the supervisor be senior to or otherwise independent of the Producing Manager under review.

B. Supervisory Controls and Independent Testing and Verification and Written Polices and Procedures for Certain Customer Activities

The NYSE proposes to require that its members develop and maintain adequate controls over each of their business activities. Under proposed Exchange Rule 342.23, these controls must provide for procedures for the independent verification and testing of

[45] *See* 17 CFR 240.17a–4.

[46] *See* Franke SIA Letter and A.G. Edwards Letter.

[47] In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

[48] 15 U.S.C. 78f(b)(5).

[49] NYSE Rule 342.13 provides, *inter alia*, that a person may qualify as a supervisor if he or she passes the NASD Sales Supervisor Qualification Examination (Series 9/10) or another examination or the NASD General Securities Principal Examination (Series 24).

[50] *SeeStaff Legal Bulletin No. 17: Remote Office Supervision,* Division, Commission, fn 39 (March 19, 2004).

[51] For example, the supervisory review of a Producing Manager may not be conducted by a qualified non-senior person in the Producing Manager's office if a qualified senior, or otherwise independent, person is available in another office of the member organization.

their business activities. The portion of the original proposal that required that the internal control procedures be ''separate and apart from the day-to-day supervision of such functions'' has been removed from the proposal. In response to commenters' concerns, the Exchange added a provision to enable members to perform an analysis on an ongoing, risk-based basis, to assess and prioritize those business activities requiring independent verification and testing, apart from the ongoing supervision that results from such procedures. The proposed rule also provides an exemption from the independent verification and testing procedures for those members who do not conduct a public business, have a capital requirement of $5,000 or less, or that employ ten or fewer registered representatives. Each member must include a summary of its efforts in the Annual Report that it files with its chief executive officer or managing partner, pursuant to Exchange Rule 342.30.

Further, proposed NYSE Rule 401(b) would require that members maintain written polices and procedures, administered pursuant to the internal control requirements of NYSE Rule 342.23, that address specified types of business conduct (transmittals of funds or securities from customer accounts or between customers and registered representatives, customer changes of address, and customer changes of investment objectives). The policies and procedures for these specified activities must include a method of customer confirmation, notification, or follow-up that can be documented. The Exchange, in response to comments, affirmed that the proposed rule would apply to business conduct affecting both institutional and retail accounts.

The Commission believes that proposed Exchange Rule 342.23, requiring NYSE members to develop adequate controls of their business activities, will enhance the quality of members' supervision and that such enhancement is appropriate. Because members are specifically required to maintain adequate controls over each of their business activities, members should be compelled to develop a supervisory system that, among other things, monitors the areas of business conduct that present a particular risk for the misappropriation of a customer's funds, securities, or account information. In this regard, the Commission notes that members would be required to maintain written policies and procedures for the activities that proposed NYSE Rule 401(b) identifies. The Commission believes that the proposed rules should help to make customers less vulnerable to members' misappropriating their funds, securities or account information. The Commission further believes that applying the requirements of NYSE Rule 401(b) to institutional account activity is appropriate because the Commission believes a broker's representation of an institutional customer's account also presents a risk of the broker's mishandling of the account. The Commission also believes that the proposed rules provide sufficient flexibility to tailor different control procedures for different types of business activity, should circumstances warrant.

The Commission believes that enabling members to employ an ongoing analysis to assess and prioritize those business activities requiring independent verification and testing provides member firms with sufficient flexibility to make risk-based judgments. Further, the Commission believes that the Exchange's removal of the requirement in the original proposal that the internal control procedures be ''separate and apart from the day-to-day supervision of [business activities]'' should provide adequate flexibility for firms to establish internal controls. The Commission notes that the NYSE and the Commission expect members to make an affirmative, informed determination that persons responsible for verification and testing of all business activities are sufficiently independent and qualified to effectively conduct such verification and testing note. The Commission acknowledges that some firms lack the size and/or resources to establish procedures without undue hardship. Accordingly, the Commission believes that excepting members and member associations that do not conduct a public business or that employ ten or fewer registered representatives, is appropriate.

C. Annual Branch Office Inspections

The Commission believes that the NYSE's proposal to enhance the requirements for annual internal branch office inspections in Rule 342(a)(b)/03 of the NYSE Interpretation Handbook should increase the likelihood that fraudulent activity with respect to handling customer accounts will be detected in a timely manner. To this end, the NYSE proposed to require that the person conducting the annual branch office inspections to be ''independent'' of the direct supervision or control of the branch office, including the Branch Office Managers, Sales Managers, District/Regional Mangers assigned to the office, or any other person performing a similar supervisory function. In response to comment letters expressing concern about the breadth of the proposed ''independence'' standard, the Exchange amended the proposal to narrow those excluded from being independent inspectors to the Branch Office Manager, any person who directly or indirectly reports to such manager, or any person to whom such manager directly reports.

The Commission believes that prohibiting persons who are under the direct supervision or control of the branch office from conducting annual inspections of those same offices should reduce conflicts of interest and lead to more objective and vigorous inspections because persons who have a significant financial interest in the success of a branch office would be precluded from inspecting it. The Commission further believes that the NYSE's proposed changes in response to commenters' concerns about the independence standard clarify which persons are eligible to conduct an annual inspection.

As part of the annual branch office inspection, the NYSE proposes that its members must independently verify and test the internal controls in several key areas including: safeguarding customer funds and securities, maintaining books and records, supervision of accounts serviced by branch office managers, transmittal of funds between customers and registered representatives or other third parties, validation of customer address changes, and validation of changes in customer account information.

The Commission believes that the areas identified in particular by the NYSE as subject to testing and verification effectively reduce the possibility of fraudulent activity in important aspects of customer account handling, but are not so broad that members will be overly burdened by inspections. In forming this belief, the Commission notes that the areas specified for internal controls testing include two types of events (transmittal of funds between a customer and a registered representative or a third party, and customer change of address) that the NYSE has proposed to require in the annual branch office inspection in proposed Exchange Rule 401(b). The Commission also believes that testing of internal controls in the remaining categories should further protect customers' funds and securities, particularly from fraudulent transfer. Finally, the Commission believes that Exchange members can adequately address to whom within a firm an inspection report must be sent in its policy and procedures manual, as the

NYSE suggests in response to NASAA's comments.

D. Discretionary Accounts

Currently, NYSE Rule 408(d) permits Exchange members to exercise discretion as to the time and price at which a customer order is executed beyond the day on which the customer grants the broker time and price discretion, without specific written authorization from the customer. The Commission believes that the NYSE's proposal to limit the time for such discretion to the end of the business day on which it was granted, absent a signed authorization from the customer to extend the authority beyond the business day, is appropriate. Such a requirement should limit the opportunity for misapplication of discretionary authority, thus furthering investor protection. The Commission also believes that this change will clarify for members and customers the length of time for which discretionary authority is granted in the ordinary course. Further, the Commission agrees with the NYSE that Exchange members must inform their customers that their authority to exercise time and price discretion terminates at the end of the day on which such discretion is granted, absent a signed authorization. The NYSE's Information Memorandum issued conjunction with this approval order is designed to remind members of this obligation.

Commenters argued that the limited duration for the exercise of time and price discretion should be applied only retail accounts, not institutional accounts. NYSE chose not to include a general institutional exemption, but instead amended NYSE Rule 408 to provide a limited exception from the requirement to obtain written authorization for good-till-cancelled orders for institutional accounts where discretion is exercised on a ''not held'' basis. The Commission believes that this exception from the general rule will provide members handling institutional accounts the flexibility they require while still providing adequate protection over client accounts. The Commission further believes that modifying the amendment to extend the institutional exception to include marketplaces other than the NYSE is consistent with principles of fair competition.

E. Maintenance of ''Account Designation Change'' Documentation

The Commission believes that the proposed amendments to Exchange Rule 410 will enhance the quality of the records that members maintain relating to customer orders and changes in customer account names or designation. The Commission believes that requiring members to preserve records of all orders for at least three years will provide an examiner with a more complete record of the orders that a member receives, not limited to just those orders transmitted to or carried by the member to the Floor of the Exchange.

The Commission also believes that enhancing the recordkeeping standards and qualification standards for the review of customer account name and designation changes is consistent with the protection of investors and the public interest. The Commission believes that requiring the qualified person to memorialize the reasons why he or she approved such a change should enhance the scrutiny that the qualified person exercises when reviewing the underlying facts giving rise to an account designation change. The Commission further believes that requiring the record of such approval to be maintained for two years in an ''easily accessible place,'' as that term is used in Rule 17a–4 under the Act, clarifies the appropriate repository for such records. Finally, the Commission believes that specifying that only persons passing an examination acceptable to the Exchange is appropriate and clarifies what types of persons can approve such a change.

F. Effective Date of Proposed Rule Change

The Commission notes that NYSE has proposed an effective date for the proposed rule change of six months from the date of Commission approval. The Commission recognizes that the proposed rule change may require members to make procedural or systems changes, and therefore believes that it is appropriate to delay the effective date of this proposed rule change for six months. Accordingly, the effective date of the proposed rule change shall be December 17, 2004.

IV. Amendment No. 4

The Commission finds good cause for approving Amendment No. 4 prior to the thirtieth day after the date of publication of notice thereof in the **Federal Register**. In Amendment No. 4, the NYSE proposed further amendments to NYSE Rules 342.19, 408(d), 408.11, and Rule 342(a)(b)/.03 in the NYSE Interpretation Handbook in response to concerns raised by commenters.[52] In Amendment No. 4, NYSE made certain technical changes, in response to commenters, to the requirements related to the supervision of managers under proposed Exchange Rule 342.19 to allow flexibility for ''independent'' but ''non-senior'' persons to conduct supervisory reviews of Producing Managers.[53] In the Amendment, the NYSE provided that both senior and ''otherwise independent'' persons may conduct supervisory reviews of Producing Managers, defined the term ''otherwise independent,'' and precluded supervisory reviews by persons earning more than 10% of their gross income from the production of the Producing Manager under review. Further, in response to commenters, the NYSE created a small firm exception to these standards for cases where the member is demonstrably so limited in size and resources, that there is no qualified person senior to, or otherwise independent of, the manager to conduct the supervisory reviews. The Commission, however, expects the NYSE to closely monitor the use of this exception to be certain that only members for whom the exception is intended take advantage of it and this exception is not abused. The Commission believes that the proposed changes in Amendment No. 4 provide for an appropriate level of enhanced flexibility for those firms that, because of size or structure, cannot appropriately designate a senior person to conduct supervisory reviews of a Producing Manager. The Commission further believes that precluding supervisory reviews from being conducted by a person who receives a greater than 10% of his or her income as an ''override'' from the activity of the Producing Manager under review appropriately balances the interest of customer protection and the efficiency of the supervision process.

In addition, in response to commenters, the Exchange, in Amendment No. 4, broadened the applicability of the exception to the proposed limitations on time and price discretion pursuant to the Exchange Rule 408(d) amendments to apply to any member that receives valid good-till-cancelled instructions issued on a ''not-held'' basis for an institutional account. The Commission believes that extending the exemption to marketplaces other than the NYSE is consistent with principles of fair competition.

Finally, in response to comments, the NYSE amended its annual branch office inspection rule to clarify that any person who directly or indirectly reports to a Branch Office Manager cannot conduct an annual inspection of

[52] *See* Section II, *supra*.

[53] *See* Polanin SIA Letter.

that member. The Commission believes that this amendment to Rule 342(a)(b)/03 in the NYSE Interpretation Handbook appropriately clarifies that branch office inspections may not be conducted by persons who indirectly report to the Branch Office Manager of the branch office under review. Therefore, for all of the foregoing reasons and the overall importance of the proposed rules, the Commission finds good cause for granting accelerated approval to Amendment No. 4 and believes that it is consistent with section 19(b)(2) of the Act.[54]

V. Text of Amendment No. 4

In Amendment No. 4, the NYSE proposed further amendments to NYSE Rules 342.19, 408(d) and 408.11, and Rule 342(a)(b)/03 in the NYSE Interpretation Handbook. The base text is that proposed in Amendment Nos. 1, 2, and 3 (*i.e.*, how the rule would appear if only Amendment Nos. 1, 2 and 3 were approved by the Commission). Changes made by Amendment No. 4 are in italics; deletions are in brackets.

* * * * *

Offices—Approval, Supervision and Control

Rule 342. (a) through (e) unchanged.

Supplementary Material.

.10 through .18 (No Change.)

.19 Supervision of *Producing* Managers.—Members and member organizations must develop and implement written policies and procedures reasonably designed to independently review and supervise customer account activity conducted by each Branch Office Manager, Sales Manager, Regional/District Sales Manager, or by any person performing a similar supervisory function. Such supervisory reviews must be performed by a qualified person pursuant to Rule 342.13 who*:* [is senior to the Manager under review.]

(a) *is either senior to, or otherwise independent of, the Producing Manager under review. For purposes of this Rule, an ''otherwise independent'' person: may not report either directly or indirectly to the Producing Manager under review; must be situated in an office other than the office of the Producing Manager; must not otherwise have supervisory responsibility over the activity being reviewed; and must alternate such review responsibility with another qualified person every two years or less. Further, if a person designated to review a Producing Manager receives an override or other income derived from that Producing Manager's customer activity that represents more than 10% of the designated person's gross income derived from the member or member organization over the course of a rolling twelve-month period, the member or member organization must establish alternate senior or otherwise independent supervision of that Producing Manager to be conducted by a qualified person, pursuant to Rule 342.13, other than the designated person receiving the income.*

(b) *If a member or member organization is so limited in size and resources that there is no qualified person senior to, or otherwise independent of, the Producing Manager to conduct the reviews pursuant to (a) above (for instance, the member or member organization has only one office, or an insufficient number of qualified personnel who can conduct reviews on a two-year rotation), the reviews may be conducted by a person, qualified pursuant to Rule 342.13, in compliance with (a) to the extent practicable.*

(c) *A member or member organization relying on (b) above must document the factors used to determine that complete compliance with all of the provisions of (a) is not possible, and that the required supervisory systems and procedures in place with respect to any Producing Manager comply with the provisions of (a) to the extent practicable.*

Discretionary Power in Customers' Accounts

Rule 408

(a) through (c) unchanged.

(d) The provisions of this rule shall not apply to discretion as to the price at which or the time when an order given by a customer for the purchase or sale of a definite amount of a specified security shall be executed. The authority to exercise time and price discretion will be considered to be in effect only until the end of the business day on which the customer granted such discretion, absent a specific, written, contrary indication signed and dated by the customer. This limitation shall not apply to time and price discretion exercised [by Floor brokers] *in an institutional account* pursuant to valid Good-Till-Cancelled instructions issued on a ''not-held'' basis. Any exercise of time and price discretion must be reflected on the order ticket.

Supplementary Material.

.10 No Change.

.11 For purposes of this rule, an ''institutional account'' shall mean the account of (i) a bank (as defined in Section 3(a)(6) of the Securities Exchange Act of 1934), (ii) a savings association (as defined in Section 3(b) of the Federal Deposit Insurance Act), the deposits of which are insured by the Federal Deposit Insurance Corporation, (iii) an insurance company (as defined in Section 2(a)(17) of the Investment Company Act of 1940), (iv) an investment company registered with the Securities Exchange Commission under the Investment Company Act of 1940, (v) a state or a political subdivision thereof, (vi) a pension or profit sharing plan, subject to ERISA, with more than $25,000,000 total assets under management, or of an agency of the United States or of a political subdivision thereof, (vii) any person that has a net worth of at least forty-five million dollars and financial assets of at least forty million dollars, or (viii) an investment adviser registered under Section 203 of the Investment Advisers Act of 1940.

Interpretation

Rule 342 Offices—Approval, Supervision and Control

(a)(b)

/03 Annual Branch Office Inspection Branch office inspections by members and member organizations are expected to be conducted at least annually pursuant to this Rule, unless it has been demonstrated to the satisfaction of the Exchange that because of proximity, special reporting or supervisory practice, other arrangements may satisfy the Rule's requirements. All required inspections must be conducted by a person who is independent of the direct supervision or control of the branch office (*i.e.,* not the Branch Office Manager, or any person who *directly or indirectly* reports to such Manager, or any person to whom such Manager directly reports). Written reports of these inspections, or the written authorization of an alternative arrangement, are to be kept on file by the organization for a minimum period of three years.

An annual branch office inspection program must include, but is not limited to, testing and independent verification of internal controls related to the following areas:

(1) Safeguarding of customer funds and securities,

(2) Maintaining books and records,

(3) Supervision of customer accounts serviced by Branch Office Managers,

(4) Transmittal of funds between customers and registered representatives and between customers and third parties,

(5) Validation of customer address changes, and

[54] 15 U.S.C. 78s(b)(2).

(6) Validation of changes in customer account information.

For purposes of this interpretation, ''annually'' means once in a calendar year.

* * * * *

VI. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether Amendment No. 4 is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments.

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/sro.shtml*); or
- Send an e-mail to *rule-comments@sec.gov*. Please include File Number SR–NYSE–2002–36 on the subject line.

Paper Comments.

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609.

All submissions should refer to File Number SR–NYSE–2002–36. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/sro.shtml*). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, NW., Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of the NYSE. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR–NYSE–2002–36 and should be submitted on or before July 14, 2004.

VII. Conclusion

It is therefore ordered, pursuant to section 19(b)(2) of the Act,[55] that the proposed rule change (SR–NYSE–2002–36), as amended, be, and it hereby is, approved, and Amendment No. 4 is approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[56]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 04–14230 Filed 6–22–04; 8:45 am]

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[55] 15 U.S.C. 78s(b)(2).

[56] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–49865; File No. SR–PCX–2004–38]

Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval to a Proposed Rule Change by the Pacific Exchange, Inc. for the Extension of a Pilot Program Limiting Liability for Trade-Throughs at the End of the Trading Day

June 15, 2004.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on April 26, 2004, the Pacific Exchange, Inc. (''PCX'' or ''Exchange'') filed with the Securities and Exchange Commission (''Commission'') the proposed rule change as described in Items I and II below, which Items have been prepared by the PCX. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons, and to grant accelerated approval to the proposed rule change.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The PCX is proposing to extend a pilot program for limitations on Trade-Through[3] liability pursuant to the Linkage Plan that occur from five minutes before the close of trading of the underlying security to the close of trading in the options class. The pilot program would be extended to January 31, 2005 and would increase the limit on Trade-Through liability during the last seven minutes of the trading day from 10 contracts to 25 contracts per Satisfaction Order.

The text of the proposed rule change is available at the Exchange and at the Commission.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the PCX included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item III below. The PCX has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The purpose of the proposed rule change is to extend the pilot provision in the PCX Rules that limits Trade-Through liability during the last seven minutes of the trading day.[4] Pursuant to the pilot currently in effect, an Exchange member's Trade-Through liability is limited to 10 contracts per Satisfaction Order[5] for the period

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] A ''Trade-Through'' is defined as a transaction in an options series at a price that is inferior to the national best bid or offer in an options series calculated by a Participant. *See* Section 2(29) of the Plan for the Purpose of Creating and Operating an Intermarket Option Linkage (''Linkage Plan''). A ''Participant'' is defined as an Eligible Exchange whose participation in the Linkage Plan has become effective pursuant to Section 4(c) of the Linkage Plan. *See* Section 2(24) of the Linkage Plan. Currently, the Participants in the Linkage Plan are the International Securities Exchange, Inc., the American Stock Exchange LLC, the Chicago Board Options Exchange, Inc., the PCX, the Philadelphia Stock Exchange, Inc. and the Boston Stock Exchange, Inc.

[4] The PCX has separately filed Joint Amendment No. 12 to the Linkage Plan to implement substantially the same change to the Linkage Plan. *See* Securities Exchange Act Release No. 49692 (May 12, 2004), 69 FR 29956 (May 19, 2004) (Notice of Joint Amendment No. 12). The Commission previously approved the pilot to implement a limitation on Trade-Through liability during the last seven minutes of the trading day on a 120-day temporary basis on January 31, 2003. *See* Securities Exchange Act Release No. 47298, 68 FR 6524 (February 7, 2003). On June 18, 2003, the Commission approved the pilot until January 31, 2004. *See* Securities Exchange Act Release No. 48055, 68 FR 37869 (June 25, 2003) (Order approving Joint Amendment No. 4). The Commission subsequently extended the pilot until June 30, 2004. *See* Securities Exchange Act Release No. 49146 (January 29, 2004), 69 FR 5618 (February 5, 2004) (Order approving Joint Amendment No. 8).

[5] A ''Satisfaction Order'' is defined as an order sent through the Options Intermarket Linkage to notify a member of another Participant of a Trade-Through and to seek satisfaction of the liability

Continued