Nasdaq charges a per share fee based on the average daily share volume executed in CAES or through the ITS/CAES linkage during a month. The fees are as follows: (1) $0.0027 per share if the average daily share volume is 0 to 499,999; and (2) $0.0025 per share if the average daily share volume is 500,000 or more. Under the current rule, these fees are subject to a maximum charge of $75 per execution. Nasdaq is proposing to eliminate these transaction charges for orders entered by a member that accesses its own Quote/Order submitted under the same or a different market participant identifier of the member for the trading of all ITS securities. Nasdaq believes that the proposed rule change reflects more accurately the existing market price levels for similar services, and, as such, will result in a more equitable allocation among members of the charges associated with the trading of ITS securities. Nasdaq also expects that the proposal will encourage greater use of SuperMontage for trading ITS securities, thereby contributing to greater competition among the available venues for executions of orders for ITS securities.

2. Statutory Basis

Nasdaq believes that the proposed rule change is consistent with the provisions of section 15A of the Act,[7] in general, and with section 15A(b)(5) of the Act,[8] which requires that the rules of the NASD provide for the equitable allocation of reasonable dues, fees and other charges among members and issuers and other persons using any facility or system which the NASD operates or controls. Nasdaq believes that it has proposed a pricing structure that is responsive to market demands. In addition, Nasdaq believes that the proposed rule change supports the efficient use of existing systems and ensures that the charges associated with such use are allocated equitably.

B. Self-Regulatory Organization's Statement on Burden on Competition

Nasdaq does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

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.

[7] 15 U.S.C. 78*o*–3.

[8] 15 U.S.C. 78*o*–3(b)(5).

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

The foregoing proposed rule change has become effective pursuant to section 19(b)(3)(A)(ii) of the Act[9] and Rule 19b–4(f)(2) thereunder,[10] because it establishes or changes a due, fee, or other charge imposed by the Association. At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate the rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.[11]

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 for (*http://www.sec.gov/rules/sro.shtml*); or

• Send an e-mail to rule-comments@sec.gov. Please include File Number SR–NASD–2004–075 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–NASD–2004–075. 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 Room. Copies of the filing also will be available for inspection and copying at the principal office of NASD. 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–NASD–2004–075 and should be submitted on or before July 14, 2004.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[12]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 04–14228 Filed 6–22–04; 8:45 am]

BILLING CODE 8010–01–P

[9] 15 U.S.C. 78s(b)(3)(a)(ii).

[10] 17 CFR 240.19b–4(f)(2).

[11] For purposes of calculating the 60-day period within which the Commission may summarily abrogate the proposed rule change under section 19(b)(3)(C) of the Act, the Commission considers that period to commence on June 4, 2004, the date Nasdaq submitted Amendment No. 1. *See* 15 U.S.C. 78s(b)(3)(C).

[12] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–49883; File No. SR–NASD–2002–162]

Self-Regulatory Organizations; Order Approving Proposed Rule Change and Amendments No. 1 and 2 by National Association of Securities Dealers, Inc. Relating to Internal Controls and Supervisory Control Amendments and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 3.

June 17, 2004.

I. Introduction

On November 4, 2002, the National Association of Securities Dealers, Inc. (''NASD'') 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 NASD members. The proposed rule change was published for comment in the **Federal Register** on November 27, 2002.[3] The Commission received 72 comment letters in response to proposed

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

[2] 17 CFR 240.19b–4.

[3] *See* Securities Exchange Act Release No. 46859 (November 20, 2002), 67 FR 70990 (November 27, 2002). 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).

rule change.[4] In response, on August 5, 2003, the NASD filed Amendment No. 1 to the proposed rule change. On August 7, 2003, the NASD filed Amendment No. 2 to the proposed rule

[4] *See* Letters from Robert J. Schoen, President, Quest Securities, Inc., to Jonathan G. Katz, Secretary, Commission, dated November 22, 2002 (''Quest Letter''); William L. Sabol, President, Mutual Securities, Inc., to Jonathan G. Katz, Secretary, Commission, dated November 26, 2002 (''Mutual Securities Letter''); Keo Sheng Lin, President, Kyson & Co., to Jonathan G. Katz, Secretary, Commission, dated November 25, 2002 (''Kyson Letter''); Hsiao-wen Kao, President, Monitor Capital Inc., to Jonathan G. Katz, Secretary, Commission, dated November 25, 2002 (''Monitor Letter''); M. Shawn Dreffin, President, National Planning Corporation, to Jonathan G. Katz, Secretary, Commission, dated December 2, 2002 (''National Planning Letter''); William Partin, President, Duerr Financial Corporation, to Jonathan G. Katz, Secretary, Commission, dated November 27, 2002 (''Duerr Letter''); Stanley C. Brooks, President and Chief Executive Officer, Brookstreet Securities Corporation, to Jonathan G. Katz, Secretary, Commission, dated December 4, 2003 (''Brookstreet Letter''); Thomas H. Oliver, President and Chief Executive Officer, United Planners' Financial Services of America, to Jonathan G. Katz, Secretary, Commission, dated December 13, 2002 (''United Planners' Letter''); Kevin P. Maas, Vice President and Director of Compliance, PrimeVest Financial Services, Inc., to Jonathan G. Katz, Secretary, Commission, received December 18, 2002 (''PrimeVest Letter''); R. Jack Conley, President and Chief Executive Officer, Vestax Securities Corporation, to Jonathan G. Katz, Secretary, Commission, dated December 17, 2002 (''Vestex Letter''); David R. Wickersham, President and Z. Jane Riley, Compliance Officer, The Leaders Group, Inc., to Jonathan G. Katz, Secretary, Commission, dated December 13, 2002 (''Leaders Letter''); Jacqueline C. Conley, Vice President, Compliance, Locust Street Securities, Inc., to Jonathan G. Katz, Secretary, Commission, dated December 13, 2002 (''Locust Letter''); John L. Dixon, President, Pacific Select Distributors, to Jonathan G. Katz, Secretary, Commission, dated December 13, 2002 (''Pacific Select Letter''); Paul M. Phalen, Assistant Vice President, Variable Product Services, Midland National Life Insurance Company, to Jonathan G. Katz, Secretary, Commission, dated December 17, 2002 (''Midland Letter''); Peter T. Wheeler, President, Commonwealth Financial Network, to Jonathan G. Katz, Secretary, Commission, dated December 17, 2002 (''Commonwealth Letter''); Nina S. McKenna, Sonnenschein, to Jonathan G. Katz, Secretary, Commission, dated December 17, 2002 (''Sonnenschein Letter''); Robert Watts, John Hancock, Financial Services, Inc., to Jonathan G. Katz, Secretary, Commission, dated December 17, 2002 and January 16, 2003 (''John Hancock Letter''); Michael L. Kerley, Vice President and Chief Legal Officer, MML Investors Services, Inc., to Jonathan G. Katz, Secretary, Commission, dated December 17, 2002 (''MML Letter''); Tom K. Rippberger, Vice President and Chief Compliance Officer, Washington Square Securities, Inc., to Jonathan G. Katz, Secretary, Commission, received December 17, 2003 (''Washington Square Letter''); Patrick H. McEvoy, President and Chief Executive Officer, Multi-Financial Securities Corporation, to Jonathan G. Katz, Secretary, Commission, dated December 16, 2002 (''Multi-Financial Letter''); Bryan R. Hill, President, Securities America, to Jonathan G. Katz, Secretary, Commission, dated December 16, 2002 (''Securities America Letter''); Neal E. Nakagiri, President and Chief Executive Officer, Associated Securities Corp., to Jonathan G. Katz, Secretary, Commission, dated December 19, 2002 (''ASC Letter''); R. Jack Conley, President and Chief Executive Officer, IFG Network Securities, Inc., to Jonathan G. Katz, Secretary, Commission, dated December 18, 2002 (''IFG Letter''); Michael D. Burns, Chief Compliance Officer, USAllianz Securities, Inc., to Jonathan G. Katz, Secretary, Commission, dated December 16, 2002 (''USAllianz Letter''); Greg Gunderson, President, Investment Centers of America, Inc., to Jonathan G. Katz, Secretary, Commission, dated December 16, 2002 (''Investment Centers Letter''); Sandy Brown, President and Chief Operating Officer, TransAmerica Financial Advisors, to Jonathan G. Katz, Secretary, Commission, dated December 16, 2002 (''TransAmerica Letter''); Jack R. Handy, Jr., President, Financial Network Investment Corporation, to Jonathan G. Katz, Secretary, Commission, dated December 13, 2002 (''Financial Network Letter''); Julius J. Anderson, Vice President, David M. Hoff, President and Zeonia Christy, Compliance Officer, First Heartland Capital, to Jonathan G. Katz, Secretary, Commission, dated December 27, 2002 (''First Heartland Letter''); David W. Schofield, Director of Operations and Compliance, FMN Capital Corporation, to Jonathan G. Katz, Secretary, Commission, dated December 18, 2002 (''FMN Letter''); Arthur F. Grant, President, Cadaret, Grant & Co., Inc., to Jonathan G. Katz, Secretary, Commission, dated December 17, 2002 (''Cadaret Grant Letter''); Charles Mazziotti, President, 21st Century Financial Services, Inc., to Jonathan G. Katz, Secretary, Commission, dated December 17, 2002 (''21st Century Letter''); J. Kemp Richardson, President, J.K.R. & Co., Inc., to Jonathan G. Katz, Secretary, Commission, dated December 10, 2002 (''J.K.R. Letter''); Dominick Del Duca, Chief Compliance Officer, ING FNC, to Jonathan G. Katz, Secretary, Commission, dated December 12, 2002 (''ING Letter''); Robert L. Hamman, President, Iron Street Securities, Inc., to Jonathan G. Katz, Secretary, Commission, dated December 24, 2002 (''Iron Street Letter''); Christopher R. Franke, Chairman, Self-Regulation and Supervisory Practices Committee, Securities Industry Association, to Jonathan G. Katz, Secretary, Commission, dated December 18, 2002 (''SIA Letter 1''); Lynn R. Niedermeier, President and Chief Executive Officer, INVEST Financial Corporation, to Jonathan G. Katz, Secretary, Commission, dated December 17, 2002 (''INVEST Letter''); Steven J. Svoboda, President, Eagle One Investments, LLC, to Jonathan G. Katz, Secretary, Commission, dated December 16, 2002 (''Eagle One Letter''); Stephen Batman, Chief Executive Officer, 1st Global, Inc., to Jonathan G. Katz, Secretary, Commission, dated December 18, 2002 (''1st Global Letter''); Thomas A. Hopkins, Chairman, Waterstone Financial Group, Inc., to Jonathan G. Katz, Secretary, Commission, dated December 16, 2002 (''Waterstone Letter''); David L. Meckenstock, Vice President and Chief Compliance Officer, Main Street Securities, LLC, to Jonathan G. Katz, Secretary, Commission, dated December 13, 2002 (''Main Street Letter''); Leesa M. Easley, Chief Legal Officer, World Group Securities, Inc., to Jonathan G. Katz, Secretary, Commission, dated December 19, 2002 (''World Group Letter''); Andrew J. Powers, President and Chief Compliance Officer, Re-Direct Securities Corporation, to Jonathan G. Katz, Secretary, Commission, dated December 13, 2002 (''RDS''); Dennis S. Kaminisi, Executive Vice President and Chief Administrative Officer, Mutual Service Corporation, to Jonathan G. Katz, Secretary, Commission, dated December 18, 2002 (''MSC Letter''); Roger W. Raber, President and Chief Executive Officer, National Association of Corporate Directors, to Jonathan G. Katz, Secretary, Commission, dated December 4, 2002 (''NACD Letter''); Rod J. Michel, President, World Trade Financial Corporation, to Jonathan G. Katz, Secretary, Commission, dated December 31, 2002 (''WORL 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''); Joan Hinchman, Executive Director, President and Chief Executive Officer, National Society of Compliance Professionals Inc., to Jonathan G. Katz, Secretary, Commission, dated January 8, 2003 (''NSCP Letter''); Minoo Spellerberg, Compliance Officer, Princor Financial Services Corporation, to Jonathan G. Katz, Secretary, Commission, dated December 16, 2002 (''Princor Letter''); Philip A. Pizelo, President, Pacific West Securities, Inc., to Jonathan G. Katz, Secretary, Commission, dated January 14, 2003 (''Pacific West Letter''); Terry L. Lister, General Counsel, Cambridge Investment Research, Inc., to Jonathan G. Katz, Secretary, Commission, dated December 20, 2002 (''Cambridge Letter''); Malcolm A. Morrison, President, Wharton Equity Corporation, to Jonathan G. Katz, Secretary, Commission, dated January 10, 2003 (''Wharton Letter''); John T. Treece, President, Liberty Life Securities LLC, to Jonathan G. Katz, Secretary, Commission, dated January 15, 2003 (''Liberty Life Letter''); Beth E. Weimer, Vice President and Chief Compliance Officer, American Express Financial Advisors Inc., to Jonathan G. Katz, Secretary, Commission, dated January 17, 2003 (''AEFA Letter''); James F. McGuire, Senior Vice President and Chief Compliance Officer, Linsco/Private Ledger, Corp, to Jonathan G. Katz, Secretary, Commission, dated January 16, 2003 (''LPL Letter''); Beverly A. Byrne, Secretary, BenefitsCorp Equities, Inc., to Jonathan G. Katz, Secretary, Commission, dated December 18, 2002 (''BenefitsCorp Letter''); Michael G. Brennan, Associate Counsel and Assistant Secretary, Woodbury Financial Services, Inc., to Jonathan G. Katz, Secretary, Commission, dated December 18, 2002 (''Woodbury Letter''); Craig Junkins, President and Chief Executive Officer, FFP Securities, to Jonathan G. Katz, Secretary, Commission, dated December 24, 2002 (''FFP Letter''); John M. Lefferts, President, AXA Advisors, LLC, to Jonathan G. Katz, Secretary, Commission, dated December 18, 2002 (''AXA Letter''); Charles Lesko, Jr., President, Lesko Securities, Inc., to Jonathan G. Katz, Secretary, Commission, dated December 24, 2002 (''Lesko Letter''); Marcia L. Martin, President, CUNA Brokerage Services, Inc., to Jonathan G. Katz, Secretary, Commission, dated December 24, 2002 (''CUNA Letter''); Robert M. Roth, President, MWA Financial Services, Inc., to Jonathan G. Katz, Secretary, Commission, dated December 24, 2002 (''MWAFS Letter''); Gregory D. Teese, Vice President, Compliance, Equity Services, Inc., to Jonathan G. Katz, Secretary, Commission, dated December 18, 2002 (''Equity Services Letter''); Selwyn J. Notelovitz, Senior Vice President, Global Compliance, Charles Schwab & Co., Inc., to Jonathan G. Katz, Secretary, Commission, dated February 25, 2003 (''Schwab Letter''); Kevin Ballou, President, Clark/Bardes Financial Services, Inc., to Jonathan G. Katz, Secretary, Commission, dated March 17, 2003 (''CBFS Letter''); Victoria Bach-Fink, Executive Vice President, Wall Street Financial Group, to Jonathan G. Katz, Secretary, Commission, dated December 18, 2002 (''Wall Street Letter''); Sandra T. Masek, Executive Vice President and Chief Compliance Officer, Rhodes Securities, Inc., to Jonathan G. Katz, Secretary, Commission, dated December 18, 2002 (''Rhodes Securities Letter''); Bridget M. Gaughan, Executive Vice President, Chief Legal and Regulatory Counsel, AIG Advisory Group, Inc., to Jonathan G. Katz, Secretary, Commission, dated January 2, 2003 (''AIG Letter''); Adam Antoniades, President and Chief Operating Officer, First Allied Securities, Inc. (''First Allied Letter'') to Jonathan G. Katz, Secretary, Commission, dated December 19, 2002; Martin Cohen, President, Balanced Financial Securities, to Jonathan G. Katz, Secretary, Commission, dated June 14, 2003 (''Balanced Financial Letter''); and Scott Lynn Fagin, Chief Operating Officer and Chief Financial Officer, The Jeffrey Matthews Financial Group, LLC, to Jonathan G. Katz, Secretary, Commission, dated July 31, 2003 (''Jeffrey Matthews Letter'').

change. On August 13, 2003, Amendments No. 1 and 2 were published for comment in **Federal Register**.[5] The Commission received 14 comments letters in response to these Amendments.[6] On December 17, 2003, NASD submitted Amendment No. 3 to the proposed rule change.[7] This Order approves the proposed rule, as amended, and accelerates approval of Amendment No. 3.

II. Description

A. Background

1. Purpose for and General Description of Proposal

The NASD'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.[8] 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 offices boxes under his control.

In an effort to ensure that members are more effectively supervised going forward, the NASD has proposed a new rule and amendments to existing rules to strengthen members' supervisory procedures and internal controls. Proposed new NASD Rule 3012 sets forth detailed requirements for members' supervisory control systems, while amendments to certain other rules complement that effort.

2. General Comments on the Proposed Rule Change

Several commenters stated that the effective enforcement of existing supervisory rules should be sufficient to protect investors.[9] These commenters frequently added that they viewed the proposed rules as an overreaction to the Gruttadauria case. The commenters stated that the Gruttadauria case was not a result of inadequate supervisory systems but, instead, was a case of a single individual intent on defrauding customers.[10]

In Amendment No. 1, NASD responded that it understood the concern that regulators not overreact to one case of violative conduct, but stated that it did not view the proposed rule change as a reaction to any particular legal or regulatory event. Rather, NASD stated that the proposed rule change is designed to enhance the current rules and examination efforts by specifically requiring members to establish adequate supervisory control systems.

Many commenters also suggested that implementing the proposed rule change would require firms to hire a large number of additional personnel to conduct the supervisory activities required by the proposed rules, thereby placing a significant financial burden on firms.[11] Some commenters believed that this cost could destroy the business model of independent contractors located in small branch offices.[12] Two commenters suggested that the proposed rule change be adopted in the form of ''principles for effective supervision'' or ''best practices'' that could be tailored to various business models rather than rules that would apply to all firms.[13]

In Amendment No. 1, NASD stated that it disagreed with the suggestion that the proposed rule change should be adopted in the form of ''principles'' or ''best practices.'' NASD stated that it believes that the degree of authority carried by the proposed rules is necessary to effectively induce appropriate conduct. However, as discussed in detail below, NASD amended its proposed rules to allow greater flexibility in certain respects, such as, to account for variations in members' business models.

B. Discretionary Accounts (NASD Rule 2510)

1. Original Proposal and Comments Received

[5] *See* Securities Exchange Act Release No. 48298 (August 7, 2003), 68 FR 48421. 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).

[6] *See* Letters from Carl B. Wilkerson, Chief Counsel, Securities and Litigation, American Counsel of Life Insurers, to Jonathan G. Katz, Secretary, Commission dated September 3, 2003 and October 3, 2003 (''ACLI Letters''); Neal E. Nakagiri, President and CEO, Associated Securities Corp., to Jonathan G. Katz, Secretary, Commission dated October 2, 2003 (''ASC Letter-2''); Pamela K. Cavness, Director of Compliance, Edward D. Jones and Co., LP, to Jonathan G. Katz, Secretary, Commission dated October 2, 2003 (''Edward Jones Letter''); Robert S. Rosenthal, Second Vice President and Associate General Counsel, Mass Mutual Financial Group, to Jonathan G. Katz, Secretary, Commission dated August 29, 2003 (''Mass Mutual Letter-2''); Dennis S. Kaminski, EVP/CAO, Mutual Service Corp., to Jonathan G. Katz, Secretary, Commission dated October 3, 2003 (''MSC Letter-2''); Barbara Black, Director, Pace University School of Law, to Jonathan G. Katz, Secretary, Commission dated October 2, 2003; S. Kendrick Dunn, Assistant Vice President, Pacific Select Distributors, to Jonathan G. Katz, Secretary, Commission dated October 3, 2003 (''Pacific Select Letter-2''); John Polanin, Jr., Chairman, Self-Regulation and Supervisory Practices Commission, Securities Industry Association, to Jonathan G. Katz, Secretary, Commission dated October 3, 2003 (''SIA Letter-2''); Terry Lister, Of Counsel, Sonnenschein, Nath & Rosenthal, LLP, to Jonathan G. Katz, Secretary, Commission dated September 30, 2003 (''Sonnenschein Letter-2''); Julie Gebert, Vice President and Director of Compliance, United Planners Financial Services of America, to Jonathan G. Katz, Secretary, Commission dated October 3, 2003 (''United Planners Letter-2''); Ralph A. Lambiase, President and Director, Connecticut Division of Securities, North American Securities Administrators Association, Inc., to Jonathan G. Katz, Secretary, Commission dated October 24, 2003 (''NASAA Letter''); Lisa Roth, President, Monahan & Roth, to Jonathan G. Katz, Secretary, Commission, dated October 30, 2003 (''M&R Letter''); and Donald Gloisten, President, GBS Financial Corporation, to Jonathan G. Katz, Secretary, Commission dated January 15, 2004. The Commission notes that the letter from Edward Jones primarily sought interpretative guidance on application of the proposed rule from the NASD. These requests are not reflected as part of the summary of comments.

[7] *See* letter from Patricia Albrecht, Assistant General Counsel, NASD to Katherine A. England, Assistant Director, Division of Market Regulation, Commission, dated December 16, 2003 (''Amendment No. 3'').

[8] *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.

[9] *See* 1st Global Letter; AIG Letter; Cambridge Letter; Schwab Letter; CBFS Letter; Commonwealth Letter; CUNA Letter; FFP Letter; First Allied Letter; INVEST Letter; Investment Centers Letter; Lesko Letter; MSC Letter; MWAFS Letter; Princor Letter; Rhodes Securities Letter; Securities America Letter; SIA Letter; TransAmerica Letter; United Planners' Letter; USAllianz Letter; Waterstone Letter; and World Group Letter.

[10] *See* 1st Global Letter; AIG Letter; Cambridge Letter; Schwab Letter; CBFS Letter; Commonwealth Letter; CUNA Letter; FFP Letter; First Allied Letter; INVEST Letter; Investment Centers Letter; Lesko Letter; MSC Letter; MWAFS Letter; Princor Letter; Rhodes Securities Letter; Securities America Letter; SIA Letter; TransAmerica Letter; United Planners' Letter; USAllianz Letter; Waterstone Letter; and World Group Letter; *see also* Associated Securities Letter; AXA Letter; Cadaret Grant Letter; Equity Services Letter; LPL Letter; NSCP Letter; and Pacific Select Letter.

[11] *See* 1st Global Letter; AIG Letter; AEFA Letter; Cambridge Letter; CBFS Letter; CUNA Letter; Equity Services Letter; FFP Letter; Financial Network Letter; First Allied Letter; IFG Letter; INVEST Letter; Investment Centers Letter; John Hancock Letters; Lesko Letter; LPL Letter; Locust Letter; Multi-Financial Letter; MSC Letter; MWAFS Letter; PrimeVest Letter; Princor Letter; Rhodes Securities Letter; Securities America Letter; TransAmerica Letter; United Planners' Letter; USAllianz Letter; Vestax Letter; Washington Square Letter; and Waterstone Letter.

[12] *See* Associated Securities Letter; AXA Advisors Letter; MSC Letter; Pacific Select Letter; SIA Letter; and Woodbury Letter.

[13] *See* 1st Global Letter and SIA Letter.

As originally proposed, changes to existing NASD Rule 2510(d)(1) required that discretionary authority as to the time or price at which an order may be executed be limited to the day it is granted, 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 NASD should craft an exemption for institutional accounts.[14] Commenters argued that large orders for institutional accounts are ''worked'' over one or more days pursuant to a Good-Till-Cancelled Order with instructions issued on a ''not held'' basis.

In Amendment No. 1, NASD responded that it believes that a general institutional exemption is inappropriate. However, in an effort to address commenters' concerns, NASD amended NASD Rule 2510 to clarify 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 effected with or for an institutional account, as that term is defined in NASD Rule 3110(c)(4), that are exercised pursuant to valid Good-Till-Cancelled instructions issued on a ''not held'' basis. NASD also amended NASD Rule 2510 to require that any exercise of time and price discretion be reflected on the customer order ticket.

Several commenters also argued that allowing time and price discretion only until the end of the business day on which the discretion was granted absent written authorization from the customer seemed unduly restrictive and would not work to advantage of customers in moving markets.[15] Commenters also requested that NASD 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.[16] NASD declined to adopt this position. In Amendment No. 1, NASD pointed out that the current text of NASD Rule 2510(d) clearly limits the exercise of time and price discretion to ''the purchase or sale of a definite amount of a specified security * * *.'' NASD noted that any written authorization granting time and price discretion must comply with this established, trade-specific standard and that customers who wish to grant more extensive discretionary authority to their registered representatives may do so pursuant to a fully executed trading authorization.

2. NASD Proposed Amendment in Response to Commenters

Thus, in Amendment No. 1, which the Commission noticed on August 7, 2003, NASD proposed amending NASD Rule 2510 to provide that 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. However, the limitation shall not apply to time and price discretion exercised for orders effected with or for an institutional account[17] pursuant to valid Good-Till-Cancelled instructions issued on a ''not-held'' basis. Further, any exercise of time and price discretion must be reflected on the customer order ticket.

C. Supervision and Internal Inspections (NASD Rule 3010)

1. Original Proposal and Comments Received

The NASD originally proposed to amend NASD Rule 3010 to require that office inspections be conducted by a person who is ''independent'' from the activities being performed at the office and the people providing supervision to that office. In addition, NASD proposed to require that office inspections include, without limitation, the testing and verification of the member's supervisory policies and procedures 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.

Several commenters agreed that requiring inspections of Offices of Supervisory Jurisdiction (''OSJs'') by persons who are not supervised by the OSJ manager makes sense and is reasonable given the facts of the Gruttadauria case.[18] However, these commenters questioned the necessity of requiring the use of ''independent'' persons to inspect branch offices.

Many commenters requested clarification regarding who would be sufficiently ''independent'' to conduct the office inspections required in NASD Rule 3010.[19] At least one commenter stated that the ''independence'' requirement proposed in NASD Rule 3010 appeared to refer to someone within the firm who does not receive compensation based on sales.[20] Commenters also stated that the ''independence'' requirement proposed in NASD Rule 3010(c) would severely reduce the number of principals eligible to conduct branch exams and would put enormous pressure on home office exam personnel to conduct more office inspections.[21] Commenters suggested that if home office exam personnel had to conduct more office inspections, the audit cycle would have to be extended to multiple-year durations and the quality of the audits would decline.[22]

Some commenters argued that the current supervisory system, which allows OSJ managers to conduct office inspections of branch and satellite offices, should be retained because it is both effective and cost efficient.[23]

[14] *See* A.G. Edwards Letter; Schwab Letter; NSCP Letter; and SIA Letter.

[15] *See* Prime Vest Letter; ING Letter; Financial Network Letter; IFG Letter; Washington Square Letter; Multi-Financial Letter; and Vestax Letter.

[16] *See* NSCP Letter and SIA Letter.

[17] *See* NASD Rule 3110(c)(4).

[18] *See* PrimeVest Letter; Financial Network Letter; Vestax Letter; and Washington Square Letter.

[19] *See* 1st Global Letter; A.G. Edwards Letter; AIG Letter; Cambridge Letter; Schwab Letter; CBFS Letter; Commonwealth Letter; CUNA Letter; FFP Letter; First Allied Letter; INVEST Letter; Investment Centers Letter; Lesko Letter; Midland Letter; MML Letter; MSC Letter; MWAFS Letter; NSCP Letter; Princor Letter; Rhodes Securities Letter; Schwab Letter; Securities America Letter; SIA Letter; United Planners' Letter; USAllianz Letter; Waterstone Letter; and World Group Letter.

[20] *See* Woodbury Letter.

[21] *See* 1st Global Letter; AIG Letter; AEFA Letter; Cambridge Letter; CBFS Letter; CUNA Letter; Equity Services Letter; FFP Letter; Financial Network Letter; First Allied Letter; IFG Letter; INVEST Letter; Investment Centers Letter; John Hancock Letter; Lesko Letter; LPL Letter; Locust Letter; Multi-Financial Letter; MSC Letter; MWAFS Letter; PrimeVest Letter; Princor Letter; Rhodes Securities Letter; Securities America Letter; TransAmerica Letter; United Planners' Letter; USAllianz Letter; Vestax Letter; Washington Square Letter; and Waterstone Letter.

[22] *See* 21st Century Letter; AIG Letter; Brookstreet Letter; Cambridge Letter; CBFS Letter; CUNA Letter; Duerr Letter; Eagle One Letter; FFP Letter; Financial Network Letter; First Allied Letter; First Heartland Letter; FMN Letter; IFG Letter; INVEST Letter; Investment Centers Letter; Iron Street Letter; JKR Letter; Kyson Letter; Lesko Letter; Liberty Life Letter; Locust Letter; Main Street Letter; Monitor Letter; Multi-Financial Letter; Mutual Securities Letter; MSC Letter; MWAFS Letter; National Planning Letter; Pacific West Letter; PrimeVest Letter; Princor Letter; Quest Letter; Rhodes Securities Letter; Securities America Letter; Leaders Group Letter; TransAmerica Letter; United Planners' Letter; USAllianz Letter; Vestax Letter; Washington Square Letter; Waterstone Letter; Wharton Letter; World Group Letter; and WORL Letter.

[23] *See* 21st Century Letter; AIG Letter; Brookstreet Letter; Cambridge Letter; CBFS Letter; CUNA Letter; Duerr Letter; Eagle One Letter; FFP Letter; Financial Network Letter; First Allied Letter; First Heartland Letter; FMN Letter; IFG Letter; INVEST Letter; Investment Centers Letter; Iron Street Letter; JKR Letter; Kyson Letter; Lesko Letter; Liberty Life Letter; Locust Letter; Main Street Letter; Monitor

Continued

Commenters noted that OSJ managers are the most familiar with registered representatives and activities located at particular offices, and therefore, are the most qualified to perform the periodic inspections. 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.[24] In addition, commenters asserted that OSJ managers' auditing of branch and satellite offices serves to reinforce their accountability for the registered representatives' actions.[25]

2. NASD Proposed Amendments in Response to Commenters

In Amendments No. 1 and 2, the NASD responded to commenters and amended NASD Rule 3010 to replace the proposed ''independence'' requirement with a provision that prohibits a branch office manager or any person within that office who has supervisory responsibilities or any individual who is supervised by such person(s) from conducting an office inspection.

Specifically, in Amendments No. 1 and 2, which the Commission noticed on August 7, 2003, NASD proposed amending NASD Rule 3010 to provide that an office inspection cannot be conducted by a branch office manager or any person within that office who has supervisory responsibilities or by any individual who is supervised by such person(s). This means that someone outside the branch office's managerial structure must conduct the inspection, such as regional or district office personnel, another branch office manager, or someone within the branch office who does not report to the branch office manager or other supervisor within the office (*e.g.*, an employee that reports to the regional or district home office).

Also, in Amendment No. 1, NASD proposed amending NASD Rule 3010 to require that members establish heightened inspection procedures in situations where the person conducting the inspection either works in an office supervised by the branch office manager's supervisor or reports to the branch office manager's supervisor and the branch office manager generates 20% or more of the income of the branch office manager's supervisor. NASD explained that the term ''heightened inspection'' means those inspection procedures that are designed to avoid conflicts of interest that serve to undermine complete and effective inspection because of economic, commercial, or financial interests that the branch office manager's supervisor holds in the associated persons and businesses being inspected.

In Amendment No. 2, NASD gave examples of heightened inspection procedures, stating that members should consider such elements as unannounced office inspections, increased frequency of inspections, a broaden scope of activities inspected, and/or having one or more principals review and approve the office's inspections. To allow members flexibility, NASD stated that these examples are meant to illustrate the type of procedures a member may want to include in its heightened inspection procedures and are not meant to be an exclusive or exhaustive list.

The proposed rule requires that an office inspection and review by a member must be reduced to a written report and kept on file by the member for a minimum of three years, unless the regular periodic schedule for the inspection is longer than a three-year cycle, in which case the report must be kept on file at least until the next inspection report has been written. The written inspection report must also include, without limitation, the testing and verification of the member's policies and procedures, including supervisory policies and procedures in the following areas: (A) Safeguarding of customer funds and securities; (B) maintaining books and records; (C) supervision of customer accounts serviced by branch office managers; (D) transmittal of funds between customers and registered representatives and between customers and third parties; (E) validation of customer address changes; and (F) validation of changes in customer account information. NASD Rule 3010, however, does not limit member testing and verification of the members' policies and procedures during an inspection to these specific areas but requires testing and verification of all relevant policies and procedures.

In addition, in Amendment No. 1, NASD amended NASD Rule 3010 to codify previous NASD guidance that non-supervisory branch offices must be inspected at least every three years based on the nature and complexity of the securities activities and that all non-branch locations must be inspected periodically, and to provide that OSJs must be inspected annually.

Finally, in Amendment No. 1, NASD deleted the provision in NASD Rule 3010(c) that would have allowed members to seek an exemption from the independence requirement in NASD Rule 3010(c) subject to specified terms and conditions, because it had removed the ''independence'' requirement regarding inspections conducted pursuant to NASD Rule 3010(c). NASD also removed its Rule 3010(c) from the list of rules in NASD Rule 9610(a) from which a member can seek an exemption.

D. Supervisory Controls (NASD Rule 3012)

1. Original Proposal and Comments Received

As originally proposed, NASD Rule 3012 required that each member establish supervisory control procedures that (a) test and verify that the member's supervisory procedures are reasonably designed to comply with the federal securities laws and regulations and NASD rules; and (b) amend the supervisory procedures where such testing and verification identifies the need to do so. NASD further proposed that the supervisory control procedures be performed by persons who are ''independent'' from those activities being tested and verified and the persons who directly supervise those activities.

One commenter stated that the proposed rule change would expand a member's existing supervisory procedures and place a more substantive emphasis on testing and verification of the member's examination processes.[26] This commenter did not believe that the change would be overly burdensome compared to the benefit derived—tightened security. Another commenter recommended that the proposed rule be limited to retail accounts.[27]

Many commenters requested clarification regarding who would be sufficiently ''independent'' to perform the supervisory control procedures required under proposed NASD Rule 3012.[28] A large number of commenters

Letter; Multi-Financial Letter; Mutual Securities Letter; MSC Letter; MWAFS Letter; National Planning Letter; Pacific West Letter; PrimeVest Letter; Princor Letter; Quest Letter; Rhodes Securities Letter; Securities America Letter; Leaders Group Letter; TransAmerica Letter; United Planners' Letter; USAllianz Letter; Vestax Letter; Washington Square Letter; Waterstone Letter; Wharton Letter; World Group Letter; and WORL Letter.

[24] *See* Schwab Letter.

[25] *Id.*

[26] *See* John Hancock Letter.

[27] *See* NSCP Letter.

[28] *See* 1st Global Letter; AIG Letter; Cambridge Letter; Schwab Letter; CBFS Letter; Commonwealth Letter; CUNA Letter; FFP Letter; First Allied Letter; INVEST Letter; Investment Centers Letter; Lesko Letter; Midland Letter; MML Letter; MSC Letter; MWAFS Letter; Princor Letter; Rhodes Securities Letter; Securities America Letter; SIA Letter; United Planners' Letter; USAllianz Letter; Waterstone Letter; and WORL Letter; *see also* Sonnenschein Letter.

thought that the proposal restricted the firms' senior supervisory personnel from performing and/or overseeing the review of a firm's supervisory control procedures, which could compromise the quality of the review. These commenters stated that the alternative approach of assigning someone from another division of the firm, such as Marketing or Operations, to perform the review could result in a supervisory review that is less sensitive to compliance requirements.[29] At least one commenter stated that the ''independence'' requirement in NASD Rule 3012 appears to refer to someone outside of the firm.[30]

In response to these concerns, in Amendments No.1 and 2, NASD amended proposed NASD Rule 3012 to eliminate the requirement that persons establishing, maintaining, and enforcing supervisory control policies and procedures be ''independent.'' Instead, NASD amended NASD Rule 3012 to require firms to designate a person who is senior to the producing manager (at any level) to perform the supervisory reviews that will test and verify that members' supervisory procedures are sufficient. In Amendments No. 1 and 2, NASD stated that this individual must not report to the producing manager, his compensation must not be determined by the producing manager, and he may not be in the same chain of authority as the producing manager.

Several commenters mentioned that the requirements originally proposed in NASD Rule 3012 to test and verify a member's supervisory procedures and make any changes identified through the testing and verification procedures appear to be substantially similar to NASD Rule 3010(a)(8), which requires a member to review the supervisory system and make any appropriate changes. Commenters stated that it would be redundant to require a member to conduct two separate, yet very similar, reviews of the member's supervisory procedures to determine if changes need to be made.[31] NASD agreed and in Amendment No. 1 modified the proposed rule change to combine the two supervisory review requirements into proposed NASD Rule 3012 and eliminate NASD Rule 3010(a)(8) altogether.

Two commenters stated that the requirement that specific supervisory controls be in place to address the transmittal of funds between accounts, changes of customers' addresses, and changes in customers' investment objectives should apply only to retail customer activity and not to institutional customer activity.[32] One commenter went on to explain that an institutional exemption was appropriate because much of that business is done on a delivery-versus-payment or receipt-versus-payment basis or via prime brokerage arrangements that involve systems and controls that are different from retail account servicing.[33] NASD responded that it is reasonable and appropriate for regulatory oversight in the sensitive areas designated in proposed NASD Rule 3012 extend to institutional account activity.

2. NASD Amendments in Response to Commenters

As described above, in Amendments No. 1 and 2, NASD amended proposed NASD Rule 3012, in response to commenters' concerns regarding the ''complete independence'' standard, to require that a member designate and specifically identify to NASD one or more principals who will establish, maintain, and enforce supervisory control procedures that will test and verify the sufficiency of the member's supervisory procedures and that create additional or amend supervisory procedures where the need is identified by such testing and verification. NASD stated that it expects that the designated principals will test and verify the adequacy of the supervisory control procedures in a manner that is independent of a member's countervailing business considerations.

Proposed NASD Rule 3012, as modified by Amendments No. 1 and 2, provides that these policies and procedures must include procedures that are reasonably designed to review and supervise the customer account activity conducted by the member's branch office managers, sales managers, regional or district sales managers, or any person performing a similar supervisory function. Proposed NASD Rule 3012 further provides that a person who is senior to the producing manager must perform these supervisory reviews. A person who does not report to the producing manager, whose compensation is not determined in whole or part by the producing manager, and is not be in the same chain of authority may be senior for the purposes of such supervision if that person has the authority to oversee, direct and correct the activities of the producing manager and take all necessary remedial actions, including termination, if and when necessary.

NASD proposed an exception to this requirement. In Amendment No. 1, NASD proposed that if a member (1) does not conduct a public business; or (2) has a capital requirement of $5,000 or less; or (3) employs ten or fewer representatives and its business is conducted in a manner necessitated by a limitation of resources that includes fewer than two layers of supervisory personnel, then a person in another office who is in the same or similar position to the producing manager may conduct the supervisory review. This exception may only be used if the person in the same or similar position to the producing manager does not have supervisory responsibility over the activity being reviewed; reports to his supervisor his supervision and review of the producing manager; and has not performed a review of the producing manager in the last two years.

Proposed NASD Rule 3012 also requires that members adopt procedures that are reasonably designed to review and monitor activities such as transmittal of funds or securities from customers to outside entities or locations other than a customer's primary residence, customer changes of address and the validation of such changes, and customer changes of investment objectives and the validation of such changes. The proposed Rule further requires that these policies and procedures include a means or method of customer confirmation, notification, or follow-up that can be documented.

In Amendments No. 1 and 2, NASD proposed that the supervisory policies and procedures required under proposed NASD Rule 3012 also include procedures reasonably designed to provide heightened supervision of the activities of each producing manager who is responsible for generating 20% or more of the revenue of the business units supervised by the branch office manager's supervisor. NASD explained that the term ''heightened supervision'' means those supervisory procedures

[29] *See* 21st Century Letter; AIG Letter; Brookstreet Letter; Cambridge Letter; CUNA Letter; Duerr Letter; Eagle One Letter; Financial Network Letter; ING Letter; First Allied Letter; First Heartland Letter; FMN Letter; IFG Letter; INVEST Letter; Investment Centers Letter; Iron Street Letter; JKR Letter; John Hancock Letter; Kyson Letter; Lesko Letter; Liberty Life Letter; Locust Letter; Main Street Letter; Monitor Letter; Multi-Financial Letter; Mutual Securities Letter; MSC Letter; MWAFS Letter; National Planning Letter; Pacific West Letter; PrimeVest Letter; Princor Letter; Quest Letter; Rhodes Securities Letter; Securities America Letter; Leaders Group Letter; TransAmerica Letter; United Planners' Letter; USAllianz Letter; Vestax Letter; Washington Square Letter; Waterstone Letter; Wharton Letter; World Group Letter; and WORL Letter.

[30] *See* Woodbury Letter.

[31] *See* CBFS Letter; Financial Network Letter; ING Letter; IFG Letter; Locust Letter; MML Letter; Multi-Financial Letter; PrimeVest Letter; Vestax Letter; and Washington Square Letter; see also Sonnenschein Letter.

[32] *See* 1st Global Letter and SIA Letter.

[33] *See* SIA Letter.

that evidence supervisory activities that are designed to avoid conflicts of interest that serve to undermine complete and effective inspection because of economic, commercial, or financial interests that the branch office manager's supervisor holds in the associated persons and businesses being supervised.

In establishing such heightened supervisory procedures, NASD stated that members should consider such elements as unannounced supervisory reviews, an increased number of supervisory reviews by different reviewers within a certain period, a broader scope of activities reviewed, and/or having one or more principals approve the supervisory review of such producing managers. These examples are meant to illustrate the type of procedures a member may want to include in its heightened supervisory procedures. NASD believes that proposed NASD Rule 3012, as amended, should allow members sufficient flexibility to create the supervisory control procedures mandated by the rule without creating undue burdens and costs.

Finally, proposed NASD Rule 3012 provides that a member that is in compliance with substantially similar requirements of the New York Stock Exchange shall be deemed to be in compliance with the supervisory control requirements set forth in NASD Rule 3012.

E. Books and Records (NASD Rule 3110)

1. Original Proposal and Comments Received

As originally proposed, the amendments to NASD Rule 3110 required that, before a customer order is executed, the account name or designation be placed upon the memorandum for each transaction. In addition, the proposed rule provided that only a designated person may approve any changes in account names or designations. The designated person also must document the essential facts relied upon in approving the changes and maintain the record in a central location. The designated person must pass a qualifying principal examination appropriate to the business of the firm before he or she can approve these changes.

One commenter to the original proposal stated that its clerical staff is responsible for making changes to account names or designations and that requiring a principal to authorize the changes and be informed of the surrounding facts would place undue burden and cost upon the firm.[34]

In response, NASD acknowledged that the proposed amendments may place additional costs and burdens upon members; however, NASD stated that it believes that account names and designations are material information that must be protected from possible fraudulent activity and that requiring a principal to authorize the change and be aware of the surrounding facts for the change is a relatively low-cost method of protecting this information.

The same commenter stated that the requirement that a name or account designation be placed on ''each transaction'' is impractical for the administration of a variable life or variable annuity policy because dozens of transactions involving expense and insurance charges automatically occur each month for the multitude of funds associated with each policy.[35]

In response, NASD noted that it proposed this rule change to promote consistency with the SEC's books and records rules. Specifically, SEC Rule 17a–3(a)(6) requires that a memorandum of each brokerage order identify, among other things, the account for which the order was entered.[36] In Amendment No. 1, NASD stated that it expects that members, regardless of the type of securities business they engage in, will comply with this requirement in the same manner that they comply with the SEC's books and records requirements.

At least one commenter requested clarification regarding whether a firm may avoid duplicate records by maintaining the ''Account Designation Change'' documentation ''in the location whether the determination and approval occurs,'' rather than in the central location of the ''Home Office.'' [37]

In response to this comment, in Amendment No. 1, NASD amended the proposed rule change to require members to preserve these records in a manner substantially similar to the record retention requirements of SEC Rule 17a–4.[38]

2. NASD Amendment in Response to Comments

Thus, NASD proposed to amend NASD Rule 3110 to require that, before a customer order is executed, the account name or designation must be placed upon the memorandum for each transaction. In addition, only a designated person may approve any changes in account names or designations. The designated person must pass a qualifying principal examination appropriate to the business of the firm before he or she can approve these changes. The designated person also must document the essential facts relied upon in approving the changes and maintain the record in a central location. Members must preserve account designation change documentation for a period of not less than three years, with the documentation preserved for the first two years in an easily accessible place, as the term ''easily accessible place'' is used in Rule 17a–4 under the Act

F. Customer Account Information (NASD Rule IM–3110)

1. Original Proposal and Comments Received

Proposed changes to NASD IM–3110 would permit a member, upon a customer's written instructions, to hold mail for a customer who will not be at his or her usual address for the period of his or her absence, but not to exceed (A) two months if the member is advised that the customer will be on vacation or traveling or (B) three months if the customer is going abroad.

At least one commenter stated that a member would have to impose additional recordkeeping and administrative controls to avoid lost or misplaced mail in situations where a customer that travels frequently looks to a member to provide custody of his or her mail.[39] Another commenter expressed concerns about the rule's application to foreign customers.[40]

2. NASD Amendment in Response to Comments

In response to these comments, in Amendment No. 2, NASD acknowledged that members that agree to hold mail for customers may have to implement additional procedures to comply with the limitations set forth in this rule. However, NASD stated that the rule will help to ensure that members that do hold mail for customers who are away from their usual addresses, do so only pursuant to the customers' written instructions and for a specified, relatively short period of time, thus reducing the likelihood that customers would not receive account statements or other account documentation at their usual addresses.

[34] *See* Midland Letter.

[35] *Id.*

[36] 17 CFR 240.17a–3(a)(6).

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

[38] 17 CFR 240.17a–4.

[39] *See* John Hancock Letter.

[40] *See* NSCP Letter.

G. Comments on the Effective Date of the Rule Change

Several commenters stated the proposed rule change may tax member resources that were already under pressure due to requirements imposed by other new rules, such as the U.S.A. Patriot Act and the Commission's books and records rules.[41] At least one commenter requested that the effective date of any new requirements be delayed for six to nine months after the approval date. [42] In response, NASD is proposing to establish an effective date of six months from SEC approval of the proposed rule change to allow members sufficient time to address any necessary procedural or system changes.

III. Summary of Comments on Proposal as Amended by Amendments No. 1 and 2 and Description of Amendment No. 3

After the publishing for comment the original proposal in the **Federal Register** on November 27, 2002, the Commission again noticed for comment the proposal, as amended by Amendments No. 1 and 2, in the **Federal Register** on August 13, 2003.[43] In response to the proposed rule, as amended, the Commission received 14 comment letters.[44] These letters and the NASD's response in Amendment No. 3 are summarized below.

A. Discretionary Accounts (NASD Rule 2510)

One commenter stated that NASD Rule 2510(d) should contain a requirement that firms notify their clients of the one-day limit on time and price discretionary authority. The commenter believed that informing customers would better protect them.[45]

In Amendment No. 3, NASD responded that it believes that the commenter may have misperceived the purpose of the amendment to NASD Rule 2510(d)(1). NASD explained that the intent of the amendment is to provide greater investor protection by clarifying the terms of an order given pursuant to price and time discretion pertaining to the time such an order remains pending, and NASD believes that the amendment achieves its stated purpose.

B. Internal Inspections (NASD Rule 3010)

One commenter suggested that NASD's codification of a minimum three-year inspection period for ''certain non-registered and/or non-supervisory branch offices'' was inappropriate and could have a detrimental effect on the overall supervisory systems for firms with remote office locations.[46] This commenter stated that the codification was contrary to previous NASD guidance regarding how often offices should be inspected. Another commenter stated that members often conduct examinations of non-supervisory branch offices more than once every three years to ensure that supervisors maintain regular and frequent professional contact but that these examinations did not always cover every area required under the amendments to proposed NASD Rule 3010.[47] The commenter requested assurance that these more frequent inspections do not violate proposed NASD Rule 3010, even if they are not designed to comply strictly with NASD Rule 3010's requirements.

In response to these comments, in Amendment No. 3, NASD explained that proposed NASD Rule 3010 requires a member to examine non-supervisory branch offices at least once every three years, and that a member may choose to examine these offices on a more frequent schedule. NASD went on to state that more frequent inspections are not equivalent to complying with the requirements of NASD Rule 3010, however, if all of the express constituent areas of supervision are not covered during the course of those examinations. NASD explained that members must consider whether the nature and complexity of a branch office's securities activities, the branch office's volume of business, and the number of associated persons assigned to the branch office require inspections more frequently than every three years. In this regard, NASD explained that members must set forth in their written supervisory and inspection procedures the examination cycle and an explanation of the factors used in determining the frequency of the cycle.

To further address the commenters' concerns, NASD also proposed a clarification to the rule text which states that if a member establishes a more frequent inspection cycle than every three years, the member must ensure that at least every three years, all the inspection requirements provided for in the rule have been met and describe in the member's written supervisory and inspection procedures, the manner in which this will be accomplished.

Two commenters suggested that NASD either eliminate, or provide greater detail on, the requirement in proposed NASD Rule 3010(c) to inspect non-branch locations on a regular periodic schedule.[48] In response NASD noted that the provision requiring members to inspect non-branch locations on a regular periodic schedule codifies previous and consistent NASD guidance on this issue.[49] NASD stated that members should already be familiar with the requirement to inspect non-branch locations and should be currently conducting such inspections.

One commenter suggested that the NASD should require chief executive officers and chief compliance officers to certify that firms have adequate compliance and supervisory policies and procedures.[50] In response to this comment, NASD stated it believes that the proposed amendments put in place appropriate measures to ensure a member's responsibilities for its supervisory control policies and procedures. NASD noted that proposed NASD Rule 3012 already requires each member to designate and identify one or more principals who will establish, maintain, and enforce a system of supervisory control policies that test and verify that the supervisory procedures are reasonably designed to achieve compliance with applicable securities laws and regulations and with applicable NASD rules. Further, NASD explained that it recently filed with the Commission a proposed rule change to require each member to designate a chief compliance officer and require the member's chief compliance officer and chief executive officer to certify annually that the member has in place process to establish, maintain, review, modify and test policies and procedures reasonably designed to achieve compliance with applicable NASD rules, Municipal Securities Rulemaking

[41] *See* Quest Letter; Mutual Securities Letter; Kyson Letter; Monitor Letter; Duerr Letter; Brookstreet Letter; United Planners Letter; PrimeVest Letter; Vestax Letter; Leaders Group Letter; Locust Letter; Commonwealth Letter; Washington Square Letter; Multi-Financial Letter; Securities America Letter; IFG Letter; TransAmerica Letter; Financial Network Letter; First Heartland Letter; FMN Letter; 21st Century Letter; JKR Letter; Iron Street Letter; SIA Letter; INVEST Letter; Eagle One Letter; 1st Global Letter; Waterstone Letter; Main Street Letter; World Group Letter; RDS Letter; MSC Letter; WORL Letter; A.G. Edwards Letter; Princor Letter; Pacific West Letter; Wharton Letter; Liberty Mutual Letter; AEFA Letter; FFP Letter; Lesko Letter; CUNA Letter; Rhodes Securities Letter; AIG Letter; and First Allied Letter.

[42] *See* Pacific Select Letter.

[43] *See* Securities Exchange Act Release No. 48298 (August 7, 2003), 68 FR 48421.

[44] *See* note 6, *supra*.

[45] *See* Pace Letter.

[46] *See* M&R Letter.

[47] *See* Mass Mutual Letter–2.

[48] *See* Pacific Select Letter-2; and United Planners Letter-2.

[49] *See* NASD *Notice to Members* 98–38 (May 1998); NASD *Notice to Members* 99–45 (June 1999).

[50] *See* Mass Mutual Letter-2.

Board rules, and the federal securities laws.[51]

One commenter stated that NASD should assure the integrity of office inspections by restricting persons responsible for office inspections from reporting directly or indirectly to the branch office's sales manager, and that NASD should also require members to send inspection reports directly to the compliance department.[52] In response to these comments, NASD noted that as proposed, the amendments to NASD Rule 3010 restrict the branch office manager or any person within that office who has supervisory responsibilities or any individual who is supervised by such persons from conducting inspections. NASD stated that it does not believe that additional restrictions on the persons appropriate to conduct office inspections would necessarily increase the integrity of office inspections.

One commenter asked whether the written reports of office inspections required by proposed NASD Rule 3010(c)(2) to be kept on file are subject to direct review by NASD examiners during the course of an examination or whether they can be made available upon request.[53] In response, the NASD explained that it expects a member to produce the office inspection reports during an examination by any self-regulatory organization if the information contained in the reports is relevant to the subject matter of the examination and if it is requested for production by a self-regulatory organization.

Finally, several commenters requested more clarification regarding who can conduct an office inspection.[54] Specifically, the commenters asked who could conduct an office inspection if a firm has small or single-person satellite offices that report to an OSJ, rather than to a separate branch office. The commenters asked whether the OSJ manager, who may also be considered the branch office manager of the small offices under some business models, could conduct the office inspection.

In response to these comments, in Amendment No. 3, NASD acknowledged that members have different business models and that some members may be so limited in both size and resources that their business models do not make it possible to comply fully with the restrictions regarding who can conduct an office inspection. Therefore, in Amendment No. 3 NASD proposed an exception to proposed NASD Rule 3010 that provides that if a member is so limited in size and resources that it cannot comply with the prohibition against office inspections being conducted by the branch office manager or any person within that office who has supervisory responsibilities or by any person who is supervised by such person, then the member may have a principal who has the requisite knowledge to conduct an office inspection perform the inspections. NASD stated that examples of such situations would include a member that has only one office or has a business model where small or single-person offices report directly to an OSJ manager who is also considered the offices' branch office manager. NASD proposed to require that a member must document in its office inspection reports the factors relied upon in determining that it is so limited in size and resources that it has no other alternative than to comply in the manner described above.[55]

Finally, one commenter raised a concern with respect to the requirement in proposed NASD Rule 3010 that a member's written inspection report include, without limitation, the testing and verification of the member's policies and procedures, including supervisory policies and procedures in the areas of safeguarding of 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.[56] Specifically, this commenter asked whether broker-dealers that did not engage in any or all of these activities would nonetheless be required to test and verify procedures governing such activities.

In response to this comment, in Amendment No. 3, NASD proposed an amendment to NASD Rule 3010 that provides that if a member does not engage in all the activities identified in the proposed rule, the member must identify those activities in which it does not engage in its written inspection report and document in the report that supervisory policies and procedures for such activities must be in place before the member can engage in them.

C. Supervisory Controls (NASD Rule 3012)

One commenter stated that NASD should not limit the scope of persons qualified to conduct a producing manager's review under NASD Rule 3012 only to those individuals who are ''senior'' to the producing manager.[57] The commenter argued that other persons within a branch office or within a firm who are not senior to the producing branch office manager should be allowed to review the producing manager, as long as that person is of an equal level of ''seniority'' and has the requisite knowledge to conduct a meaningful review.

In Amendment No. 3, NASD responded that it understands the concern that members may have to make changes to their supervisory review procedures to comply with this seniority requirement. NASD believes, however, that requiring the producing manager's reviewer to be senior to the producing manager is essential to protecting investors and helping to ensure that events, such as those that led to the Gruttadauria case, do not occur again. NASD noted that the determination of seniority is a facts and circumstances test, and that for the purposes of supervision, a person who does not report to the producing manager, whose compensation is not determined in whole or part by the producing manager and who is not in the same line of authority, may be senior for the purposes of supervision if that person has the authority to oversee, direct, and correct the activities of the producing manager and take all necessary remedial actions, including termination, if and when necessary.

NASD also pointed out that the rule as currently proposed provides for an exception to the ''seniority'' requirement. Specifically, the proposed rule states that for members who (1) do not conduct a public business; or (2) have a capital requirement of $5,000 or less; or (3) employ 10 or fewer employees and in the case of (1) through (3), have fewer than two layers of supervisory personnel, a person in another office who is in the same or similar position to the producing

[51] *See* Securities Exchange Act Release No. 48981 (December 23, 2003), 68 FR 75704 (December 31, 2003) (NASD–2003–176).

[52] *See* NASAA Letter.

[53] *See* ASC Letter-2.

[54] *See* Mass Mutual Letter-2; and Sonnenschein, Letter-2.

[55] NASD notes, however, that the ''heightened inspection'' procedures in proposed NASD Rule 3010(c)(3) would be applicable to a member availing itself of the ''limited size and resources'' exception to the prohibition against office inspections being conducted by the branch office manager or any person within that office who has supervisory responsibilities or by any person who is supervised by such person. Telephone conversation between Patricia Albrecht, Assistant General Counsel, NASD and Florence Harmon, Senior Special Counsel Division, Commission on April 15, 2004.

[56] *See* ACLI Letters.

[57] *See* SIA Letter-2.

manager may conduct the supervisory reviews, provided that the person does not have supervisory authority over the activity being reviewed, reports to his supervisor his supervision and review, and has not performed a review of the producing manager in the last two years.

Nevertheless, NASD stated in response to commenters that it understands that some members may be so limited in both size and resources that their business models do not make it possible to meet all of the exception's above-mentioned prerequisites. Therefore, in Amendment No. 3, the NASD proposed an additional exception from the ''seniority'' requirement.

The exception would provide that if a member is so limited in size and resources that it cannot avail itself of the above-described exception (*i.e.,* the member has only one office or has two offices, but an insufficient number of qualified personnel who can conduct reviews on a two-year rotation), the member may have a principal who is sufficiently knowledgeable of the member's supervisory control procedures conduct the reviews. NASD further proposed to require that the member document in its supervisory control procedures the factors it relied upon in determining that its size and the resources available to it are so limited that the member has no other alternative than to comply in this manner.[58]

One commenter requested clarification regarding whether a member could comply with NASD Rule 3012, with respect to changes of customer address and investment objectives and validation of such changes if the member follows the procedures set forth in SEC Rule 17a–3(a)(17)(i).[59] In response, NASD explained that proposed NASD Rule 3012(a)(2)(B) requires members to have in place supervisory control policies and procedures that include procedures that are reasonably designed to review and monitor all transmittals of customer funds and securities, and customer address and investment objectives changes, and the validation of such changes. NASD stated that proposed NASD Rule 3012(a)(2)(B) was not designed to address the specific measures a member should adopt regarding the supervision of changes in a customer's address or investment objectives. Further, NASD noted compliance with SEC Rule 17a–3(a)(17)(i)'s recordkeeping provisions may not be sufficient under all facts and circumstances to discharge a firm's supervisory requirements under proposed NASD Rule 3012(a)(2)(B) and that to avoid potential problems, members should ensure that they comply with both proposed NASD Rule 3012(a)(2)(B) and Rule 17a–3(17)(i) under the Act.

Another commenter requested that NASD delete proposed NASD Rule 3012's provision allowing a ''dual'' NASD/NYSE member to satisfy Rule 3012's requirements if the member satisfies substantially similar requirements promulgated by the NYSE.[60] The commenter argued that proposed NASD Rule 3012 is more specific and detailed than comparable supervisory control requirements proposed by the NYSE.

NASD responded that it is retaining proposed NASD Rule 3012's originally proposed provision that any member in compliance with substantially similar requirements of the NYSE shall be deemed to be in compliance with NASD Rule 3012. As NASD stated in its response to comments to the original rule filing, NASD believes that this provision helps promote consistency between NASD's and the NYSE's supervisory control requirements.

Several commenters requested clarification regarding the 20% threshold contained in proposed NASD Rules 3010 and 3012.[61] Specifically, commenters identified three concerns regarding the threshold: (1) How to structure compensation; (2) what time period to use to calculate the 20% threshold; and (3) whether the 20% threshold can be viewed as a ''safe harbor.'' In addition, at least one commenter asked for clarification regarding who is considered to be the producing manager's supervisor if the producing manager is supervised directly by the member's compliance department.[62]

In Amendment No. 3, NASD amended NASD Rules 3010 and 3012 to address the commenters' concerns regarding compensation structure and time periods for calculation. NASD proposed to replace the 20% threshold of income of the producing manager's supervisor with a threshold of 20% of the revenue of the business units supervised by the producing manager's supervisor. For purposes of determining the 20% revenue threshold, under the proposed rule, all revenue generated by or credited to the branch office or the branch office manager would be attributed as revenue generated by the business unit or units supervised by the branch office manager's supervisor irrespective of the internal allocation of such revenue by the member. NASD also clarified that a member must calculate the 20% threshold on a rolling, twelve-month basis.

NASD explained that if a producing manager does not have an individual assigned to supervise him, but rather, is supervised directly by the member's compliance department, then the revenue produced would be attributable to a business unit supervised by the compliance department, and if such revenue constituted 20% or more of all the supervised revenue attributable to the compliance department, then the member must have in place heightened inspection and supervisory procedures. Finally, NASD explained that it does not view the 20% threshold as a ''safe harbor,'' but rather, as a trigger for determining when a member clearly must put in place heightened inspection and/or supervisory procedures.

Finally, one commenter raised a concern with respect to the requirement in proposed NASD Rule 3012 that members establish, maintain, and enforce written supervisory control policies and procedures, including procedures that are reasonably designed to review and monitor the transmittals of funds from customer accounts to locations other than a customer's primary residence and between customers and registered representatives; customer changes of address and validation of such changes of address; and customer changes of investment objectives and the validation of such changes of investment objectives.[63] Specifically, this commenter asked whether broker-dealers that did not engage in all of these activities would nonetheless be required to institute policies governing such activities.

In response to this comment, in Amendment No. 3, NASD proposed an amendment to NASD Rule 3012 that provides that if a member does not engage in all the activities identified in the proposed rule, the member must identify those activities in which it does

[58] NASD notes, however, that the ''heightened supervision'' procedures in proposed NASD Rule 3012(a)(2)(C) would be applicable to a member availing itself of the ''limited size and resources'' exception from the requirement that a person senior to the producing manager perform supervisory reviews. Telephone conversation between Patricia Albrecht, Assistant General Counsel, NASD and Florence Harmon, Senior Special Counsel, Division, Commission on April 15, 2004.

[59] *See* Sonnenschein Letter-2.

[60] *See* Securities Exchange Act Release No. 48299 (August 7, 2003), 68 FR 48431 (August 13, 2003); *See* Securities Exchange Act Release No. 46858 (November 20, 2002), 67 FR 70994 (November 27, 2002).

[61] *See* ASC Letter-2; Pacific Select Letter-2; SIA Letter-2; Sonnenschein Letter-2; and United Planners Letter-2.

[62] *See* Sonnenschein Letter-2.

[63] *See* ACLI Letters.

not engage in its written supervisory control policies and procedures and document in those policies and procedures that additional supervisory policies and procedures for such activities must be in place before the member can engage in them.

D. Holding of Customer Mail (NASD IM–3110)

One commenter stated that NASD should provide a limited exception that would allow a firm, when necessary, to receive and hold a customer's mail for a longer time than the two-month and three-month limits proposed in IM–3110(i).[64]

NASD responded that it continues to believe that the time periods mentioned in the rules are appropriate. As NASD stated in the response to comments to the original rule filing, it believes that the amendments to NASD IM–3110(i) will help to ensure that members that do hold mail for customers who are away from their usual addresses, do so only pursuant to the customers' written instructions and for a specified, relatively short, period of time.

IV. 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 association.[65] In particular, the Commission finds that the proposal, as amended, is consistent with the provisions of Section 15A(b)(6) of the Act,[66] which requires, among other things, that a national securities association's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The Commission finds that NASD's proposal, as amended, is designed to accomplish these ends by requiring members to establish more extensive supervisory and supervisory control procedures to monitor customer account activities of their employees and thereby reduce the potential for customer fraud and theft.

A. Discretionary Accounts (NASD Rule 2510)

Currently, NASD Rule 2510(d)(1) allows members to exercise time and price discretion on orders for the purchase or sale of a definite amount of a specified security without prior written authorization from the customer and prior written approval by the member, but does not specify the duration of such discretionary authority. The Commission believes that NASD'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 providing otherwise, is appropriate. Such a control 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.

Commenters argued that the limited duration for the exercise of time and price discretion should be applied only retail accounts, not institutional accounts. NASD chose not to include a general institutional exemption, but instead amended NASD Rule 2510 to provide a limited exception from the requirement to obtain written authorization for good-til-cancel 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.

B. Supervision and Internal Inspections (NASD Rule 3010)

The Commission believes that NASD's proposal with respect to internal inspections should increase the likelihood that fraudulent activity with respect to handling customer accounts will be detected in a timely manner. To this end, proposed NASD Rule 3010 requires each member to inspect every office of supervisory jurisdiction and any branch office that supervises one or more non-branch locations at least annually. Branch offices that do not supervise one or more branch locations must be inspected at least every three years, and members must inspect non-branch locations on a regular, periodic schedule depending on the nature and complexity of the securities activities for which the location is responsible and the nature and extent of customer contact.

As part of the inspection, members must test and verify the policies and procedures in several key areas, including the supervision policies and procedures governing: 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 change of address; and validation of customer account information. The findings of the inspection must be reduced to a written report and kept on file for a minimum of three years, unless the next inspection is not due for more than three years, in which case the report must be kept on file until the next inspection report has been written.

The Commission believes that the areas identified in particular by NASD 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. Further, the Commission believes that it is appropriate for member firms to retain a written record of the findings of the inspection to help ensure that necessary modifications to policies and procedures are made promptly and in accordance with the findings of the inspection.

Proposed NASD Rule 3010 also dictates who is ineligible to conduct an inspection. Specifically, the proposed rule provides that office inspections may not be conducted by the branch office manager or any person within that office who has supervisory responsibilities or by any individual who is supervised by such a person. After careful consideration of the comments, the Commission believes that these are appropriate limitations on who may conduct office inspections. The Commission believes that these limitations 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.

In Rule 3010, NASD proposed an exception from the above requirement for firms that are so limited in size and resources that they cannot comply with this limitation. The Commission finds reasonable the NASD's examples of such situations as a member that has only one office or has a business model where small or single-person offices report directly to an OSJ manager who is considered the offices' branch manager. In such cases, a member may have a principal who has the requisite knowledge to conduct an office inspection perform the inspection. NASD, however, proposes to require that any member utilizing this exception document in its office inspection report the factors it has relied upon in

[64] *See* ASC Letter-2.

[65] 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).

[66] 15 U.S.C. 78o–3(b)(6).

determining that it is so limited in size and resources that it has no alternative other than to comply in this manner.

The Commission believes that this exception is warranted for those firms that can demonstrate and document that, as a result of their size and structure, they cannot comply with the proposed rule's limitation on who may conduct office inspections. The Commission, however, expects NASD 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 that this exception is not abused.

In NASD Rule 3010, NASD also included a provision requiring heightened office inspection procedures if the person conducting the inspection either works in an office supervised by the branch office manager's supervisor or reports to the branch office manager's supervisor *and* the branch office manager generates 20 percent or more of the revenue of the business units supervised by the branch office manager's supervisor. The Commission expects that this provision will reduce potential conflicts of interest in situations when the individual conducting the inspection, though not reporting to the branch office manager or any individual with supervisory responsibilities in the office being inspected, works in an office that receives substantial revenues from the branch office being inspected. The Commission notes that these ''heightened inspection'' procedures also apply to a member availing itself of the above ''limited size and resources'' exception in proposed NASD Rule 3010(c)(3). The Commission believes that such heightened inspection procedures should help address conflicts of interest with sufficient flexibility so as not to create undue burdens and costs on members. However, the Commission expects NASD to carefully monitor member compliance with such procedures to ensure that members are, in fact, adequately addressing such conflicts.

C. Supervisory Controls (NASD Rule 3012)

The Commission notes that NASD proposed new procedures for ensuring that adequate supervisory control policies are in place. NASD has proposed to require that each member designate one or more principals who would be responsible for establishing, maintaining, and enforcing a system of supervisory controls that, in general, test and verify that the member's supervisory procedures are reasonably designed to achieve compliance with applicable securities laws and regulations and NASD rules. The designated principal or principals must submit to the member's senior management no less than annually, a report detailing each member's system of supervisory controls, the summary of the test results and significant identified exceptions, and any additional or amended supervisory procedures created in response to the test results.

More specifically, the designated principal must establish, maintain, and enforce procedures that are reasonably designed to review and supervise the customer account activity conducted by branch office managers, sales managers, regional or district sales managers, or any person performing a similar supervisory function. NASD proposed that a person who is senior to the producing manager must conduct such supervision, unless the member meets certain criteria [67] and its business is conducted in a manner necessitated by a limitation of resources that includes fewer than two layers of supervisory personnel. In such a case, a person in another office in a position similar to the producing manager may conduct supervisory reviews provided that such person does not have supervisory responsibility over the activity being reviewed, reports to his supervisor his supervision and review of the producing manager, and has not performed a review of the producing manager in the last two years. The Commission believes that these limitations should help assure that supervision of customer account activity is objective and not subject to conflicts of interest, while at the same time accommodating legitimate limitations of small firms.

NASD proposed an additional exception from the requirement that a person who is senior to the producing manager must conduct the supervisory reviews for a member whose size and resources are so limited that it cannot avail itself of the exception. In such situations, a member may have a principal who is sufficiently knowledgeable of the member's supervisory control procedures conduct the reviews required by NASD Rule 3012.[68] The Commission finds reasonable the NASD's examples of such situations as a member with only one office or a member with two offices and an insufficient number of qualified personnel who can conduct reviews on a two-year rotation. However, any such member must document in its supervisory control procedures the factors it relied upon in determining that its size and the resources available to it are so limited that it has no alternative than to comply in this manner. The Commission expects NASD to carefully monitor use of this exception to be certain that only members for whom the exception is intended take advantage of it and that this exception is not abused.

In addition, as with NASD Rule 3010, NASD has included in proposed Rule 3012 a provision requiring heightened supervision over activities of each producing manager who is responsible for generating 20% or more of the revenue of the business units supervised by the producing manager's supervisor. The Commission expects this provision will reduce potential conflicts of interest in situations where the producing branch manager is responsible for generating substantial revenues for the benefit of his supervisor. The Commission believes that such heightened supervisory procedures should help address the potential conflicts of interest with sufficient flexibility so as not to create undue burdens and costs on members. However, the Commission expects NASD to carefully monitor member compliance with such procedures to ensure that members are, in fact, adequately addressing such conflicts.

In sum, the Commission believes that specifically requiring review and supervision of customer account activity conducted by branch office managers, sales managers, regional/district managers or any other supervisory personnel by a person senior to the producing manager, except in limited circumstances, is appropriate so that supervisors do not perform the final review of their own sales activity, nor are they able to put undue or even unintentional pressure on subordinates who might otherwise be responsible for conducting a review.

Further, the Commission believes that the two exceptions delineated by NASD for when a member need not require supervision by someone senior to the producing manager are appropriate to give relief to members whose size and/or structure would make application of the general rule impractical. The Commission, however, expects the NASD to closely monitor the use of these two exceptions to be certain that only members for whom they are intended, in fact, use these exceptions, and that these exceptions are not abused.

[67] The proposed rule text provides that these criteria are that the member does not conduct a public business, has a capital requirement of $5,000 or less, or employs 10 or fewer representatives.

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

D. Books and Records (NASD Rule 3110)

The Commission believes that NASD's proposal to require that a qualified, designated person approve and document the basis for any change in account name or designation is appropriate. The Commission recognizes that changes in account names and designations in connection with order executions can be subject to abuse and believes that requiring that a designated person authorize changes to account names or designations before they may be made, as well as requiring that the designated person document the essential facts relied upon, should help to protect against such abuse.

The Commission further believes that NASD's proposed requirement that members preserve the documentation of the essential facts relied upon in approving changes for a period of not less than three years, the first two in an easily accessible place, as that term is used in SEC Rule 17a–4, is appropriate. This requirement should enable members to use existing recordkeeping systems, as the proposed requirement is substantially similar to the record retention requirements of Rule 17a–4 under the Act.

E. Customer Account Information (IM–3110)

The Commission believes that NASD's proposal to permit members to hold customer mail only upon the written instructions of a customer, and only for two months if the member is advised that the customer will be on vacation or traveling, and only for three months if the customer is going abroad, is appropriate. The Commission believes that limiting the period of time during which members may hold mail for customers will reduce the risk of customers not receiving account statements or other account documentation for their review at their usual addresses. The Commission believes that the proposed rule change will assist customers in ensuring that the information contained in their account statements or other account documentation is accurate and in accordance with their stated goals.

F. Effective Date of Proposed Rule Change

The Commission notes that NASD 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. 3

The Commission finds good cause for approving Amendment No. 3 prior to the thirtieth day after the date of publication of notice thereof in the **Federal Register**. In Amendment No. 3, NASD made clarifying changes to proposed NASD Rules 3010 and 3012 in response to concerns raised by commenters.[69] Further, the Commission believes these change do not significantly alter the original proposal, which was subject to a full notice and comment period.

In addition, in Amendment No. 3, NASD responded to concerns raised by commenters that because of their limited size and resources, they would not be able to comply with the requirements regarding who is eligible to conduct inspections and supervisory reviews. In response to these concerns, NASD proposed alternative means of compliance for members whose size and resources are so limited that they could not comply with the requirements of proposed NASD Rules 3010 and 3012 as proposed in Amendments No. 1 and 2. The Commission believes that NASD's proposed changes in Amendment No. 3 adequately address commenters' concerns and provide a reasonable alternative for members that could otherwise comply with the proposed rules.

Therefore, for all the foregoing reasons and the overall importance of the proposed rules, the Commission finds good cause for granting accelerated approval to Amendment No. 3, and believes that it is consistent with Section 19(b)(2) of the Act.[70]

V. Text of Amendment No. 3

In Amendment No. 3, NASD proposed further amendments to NASD Rules 3010 and 3012. The base text is that proposed in Amendment Nos. 1 and 2 (*i.e.*, how the rule would appear if only Amendment Nos. 1 and 2 were approved by the Commission). Changes made by Amendment No. 3 are in italics; deletions are in brackets.

* * * * *

3010. Supervision

(a) Supervisory System

Each member shall establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules. Final responsibility for proper supervision shall rest with the member. A member's supervisory system shall provide, at a minimum, for the following:

(1) through (7) No change.

(b) No change.

(c) Internal Inspections

(1) Each member shall conduct a review, at least annually, of the businesses in which it engages, which review shall be reasonably designed to assist in detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations, and with applicable NASD rules. Each member shall review the activities of each office, which shall include the periodic examination of customer accounts to detect and prevent irregularities or abuses.

(A) Each member shall inspect at least annually every office of supervisory jurisdiction and any branch office that supervises one or more non-branch locations.

(B) Each member shall inspect at least every three years every branch office that does not supervise one or more non-branch locations. In establishing how often to inspect each non-supervisory branch office, the firm shall consider whether the nature and complexity of the securities activities for which the location is responsible, the volume of business done, and the number of associated persons assigned to the location require the non-supervisory branch office to be inspected more frequently than every three years. *If a member establishes a more frequent inspection cycle, the member must ensure that at least every three years, the inspection requirements enumerated in paragraph (c)(2) have been met.* The non-supervisory branch office examination cycle[and], an explanation of the factors the member used in determining the frequency of the examinations in the cycle*, and the manner in which a member will comply with paragraph (c)(2) if using more frequent inspections than every three years* shall be set forth in the member's written supervisory and inspection procedures.

(C) Each member shall inspect on a regular periodic schedule every non-branch location. In establishing such schedule, the firm shall consider the nature and complexity of the securities activities for which the location is responsible and the nature and extent of

[69] *See* Sections III.B. and C., *supra.*

[70] 15 U.S.C. 78s(b)(2).

contact with customers. The schedule and an explanation regarding how the member determined the frequency of the examination schedule shall be set forth in the member's written supervisory and inspection procedures.

Each member shall retain a written record of the dates upon which each review and inspection is conducted.

(2) An office inspection and review by a member pursuant to paragraph (c)(1) must be reduced to a written report and kept on file by the member for a minimum of three years, unless the inspection is being conducted pursuant to paragraph (c)(1)(C) and the regular periodic schedule is longer than a three-year cycle, in which case the report must be kept on file at least until the next inspection report has been written. The written inspection report must also include, without limitation, the testing and verification of the member's policies and procedures, including supervisory policies and procedures in the following areas:

(A) Safeguarding of customer funds and securities;

(B) Maintaining books and records;

(C) Supervision of customer accounts serviced by branch office managers;

(D) Transmittal of funds between customers and registered representatives and between customers and third parties;

(E) Validation of customer address changes; and

(F) Validation of changes in customer account information.

If a member does not engage in all of the activities enumerated above, the member must identify those activities in which it does not engage in the written inspection report and document in the report that supervisory policies and procedures for such activities must be in place before the member can engage in them.

(3) An office inspection by a member pursuant to paragraph (c)(1) may not be conducted by the branch office manager or any person within that office who has supervisory responsibilities or by any individual who is supervised by such person(s). *However, if a member is so limited in size and resources that it cannot comply with this limitation* (*e.g., a member with only one office or a member with a business model where small or single-person offices report directly to an office of supervisory jurisdiction manager who is also considered the offices' branch office manager), the member may have a principal who has the requisite knowledge to conduct an office inspection perform the inspections. The member, however, must document in the office inspection reports the factors it has relied upon in determining that it is so limited in size and resources that it has no other alternative than to comply in this manner.*

A member must have in place procedures that are reasonably designed to provide heightened office inspections if the person conducting the inspection reports to the branch office manager's supervisor or works in an office supervised by the branch manager's supervisor and the branch office manager generates 20% or more of the revenue [income] of the *business units supervised by the* branch office manager's supervisor. For the purposes of this subsection only, the term ''heightened inspection'' shall mean those inspection procedures that are designed to avoid conflicts of interest that serve to undermine complete and effective inspection because of the economic, commercial, or financial interests that the branch manager's supervisor holds in the associated persons and businesses being inspected. *In addition, for the purpose of this section only, when calculating the 20% threshold, all of the revenue generated by or credited to the branch office or branch office manager shall be attributed as revenue generated by the business units supervised by the branch office manager's supervisor irrespective of a member's internal allocation of such revenue. A member must calculate the 20% threshold on a rolling, twelve-month basis.*

* * * * *

(g) Definitions

(1) No change.

(2) (A) ''Branch Office'' means any location identified by any means to the public or customers as a location at which the member conducts an investment banking or securities business, excluding:

(A) through (D) renumbered as (i) through (iv).

(B) Notwithstanding the exclusions provided in paragraph (2)(A), any location that is responsible for supervising the activities of persons associated with the member at one or more non-branch locations of the member is considered to be a branch office.

(3) No change.

3012. Supervisory Control System

(a) General Requirements

(1) Each member shall designate and specifically identify to NASD one or more principals who shall establish, maintain, and enforce a system of supervisory control policies and procedures that (A) test and verify that the member's supervisory procedures are reasonably designed with respect to the activities of the member and its registered representatives and associated persons, to achieve compliance with applicable securities laws and regulations, and with applicable NASD rules and (B) create additional or amend supervisory procedures where the need is identified by such testing and verification. The designated principal or principals must submit to the member's senior management no less than annually, a report detailing each member's system of supervisory controls, the summary of the test results and significant identified exceptions, and any additional or amended supervisory procedures created in response to the test results.

(2) The establishment, maintenance, and enforcement of written supervisory control policies and procedures pursuant to paragraph (a) shall include:

(A) Procedures that are reasonably designed to review and supervise the customer account activity conducted by the member's branch office managers, sales managers, regional or district sales managers, or any person performing a similar supervisory function. A person who is senior to the producing manager must perform such supervisory reviews. However, if a member *(i)* does not conduct a public business, *(ii)* or has a capital requirement of $5,000 or less, or *(iii)* employs 10 or fewer representatives, and, *in the case of (i) through (iii),* its business is conducted in a manner necessitated by a limitation of resources that includes fewer than two layers of supervisory personnel, a person in another office *of the member* who is in the same or similar position to the producing manager may conduct the supervisory reviews, provided that the person in the same or similar position does not have supervisory responsibility over the activity being reviewed, reports to his supervisor his supervision and review of the producing manager, and has not performed a review of the producing manager in the last two years. *If a member is so limited in size and resources that it cannot avail itself of this exception* (*e.g., a member with only one office or a member with two offices and an insufficient number of qualified personnel who can conduct reviews on a two-year rotation), a member may have a principal who is sufficiently knowledgeable of the member's supervisory control procedures conduct these reviews. The member, however, must document in its supervisory control procedures the factors it has relied upon in determining that its size and resources available to it are so limited that the member has no*

other alternative than to comply in this manner;

(B) Procedures that are reasonably designed to review and monitor the following activities:

(i) All transmittals of funds (*e.g.*, wires or checks, etc.) or securities from customers and third party accounts (*i.e.*, a transmittal that would result in a change of beneficial ownership); from customer accounts to outside entities (*e.g.*, banks, investment companies, etc.); from customer accounts to locations other than a customer's primary residence (*e.g.*, post office, ''in care of'' accounts, alternate address, etc.); and between customers and registered representatives, including the hand-delivery of checks;

(ii) Customer changes of address and the validation of such changes of address; and

(iii) Customer changes of investment objectives and the validation of such changes of investment objectives.

The policies and procedures established pursuant to paragraph (a)(2)(B) must include a means or method of customer confirmation, notification, or follow-up that can be documented. *If a member does not engage in all of the activities enumerated above, the member must identify those activities in which it does not engage in its written supervisory control policies and procedures and document in those policies and procedures that additional supervisory policies and procedures for such activities must be in place before the member can engage in them*; and

(C) Procedures that are reasonably designed to provide heightened supervision over the activities of each producing manager who is responsible for generating 20% or more of the [income] *revenue* of the *business units supervised by the* producing manager's supervisor. For the purposes of this subsection only, the term ''heightened supervision'' shall mean those supervisory procedures that evidence supervisory activities that are designed to avoid conflicts of interest that serve to undermine complete and effective supervision because of the economic, commercial, or financial interests that the supervisor holds in the associated persons and businesses being supervised. *In addition, for the purpose of this section only, when calculating the 20% threshold, all of the revenue generated by or credited to the branch office or branch office manager shall be attributed as revenue generated by the business units supervised by the branch office manager's supervisor irrespective of a member's internal allocation of such revenue. A member must calculate the 20% threshold on a rolling, twelve-month basis.*

(b) Dual Member

Any member in compliance with substantially similar requirements of the New York Stock Exchange, Inc. shall be deemed to be in compliance with the provisions of this Rule.

* * * * *

VI. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether Amendment No. 3 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–2002–162 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–NASD–2002–162. 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 offices of the NASD. 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–NASD–2002–162 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,[71] that the proposed rule change (SR–NASD–2002–162), as amended, be, and it hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[72]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 04–14232 Filed 6–22–04; 8:45 am]

BILLING CODE 8010–01–P

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–49857; File No. SR–NASD–2004–078]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. To Establish Certain Qualification Requirements for Supervisors of Research Analysts

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 May 10, 2004, the National Association of Securities Dealers, Inc. (''NASD''), filed with the Securities and Exchange Commission (''SEC'' or ''Commission'') the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

NASD is proposing a rule change to amend NASD Rule 1022 to establish certain qualification requirements for supervisors of research analysts. More specifically, the proposed rule change would require supervisors of research analysts to pass the regulatory part (Series 87) of the Research Analyst Qualification Examination or the Series 16 Supervisory Analyst Examination administered by the New York Stock Exchange (''NYSE'').

[71] 15 U.S.C. 78s(b)(2).

[72] 17 CFR 200.30–3(a)(12).

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

[2] 17 CFR 240.19b–4.