

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>5</sup>

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*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-46859; File No. SR-NASD-2002-162]

### Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing of Proposed Rule Change Relating to Supervisory Control Amendments

November 20, 2002.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on November 4, 2002, the National Association of Securities Dealers, Inc. ("NASD") filed with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change. The proposed rule change is described in Items I, II, and III below, which Items have been prepared by the 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

The NASD is proposing to adopt new NASD Rule 3012 and amend other rules regarding the supervisory and supervisory control procedures of member firms. Specifically, new NASD Rule 3012 would require members to develop general and specific supervisory control procedures that independently test and verify and modify, where necessary, the members' supervisory procedures. In addition, proposed amendments to (1) NASD Rule 3010(c) would require that office inspections be conducted by independent persons and include, at a minimum, the testing and verification of certain supervisory procedures; (2) NASD Rule 3110 would expand upon a member's supervisory and recordkeeping requirements with respect to changes in customer account name or designation in connection with order executions; (3) NASD IM-3110 would provide guidance as to when a member may hold mail for a customer

who will be absent for a period of time; (4) NASD Rule 2510(d) would clarify the time limit on time-and-price discretionary authority; and (5) NASD Rule 9610 would incorporate into NASD Procedural Rules the ability of members to request an exemption from amended NASD Rule 3010(c). Below is the text of the proposed rule change. Proposed new language is in *italics*; proposed deletions are in brackets.

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#### 2510. Discretionary Accounts

(a) through (c) No Change.

(d) Exceptions

This Rule shall not apply to:

(1) discretion as to the price at which or the time when an order given by a customer for the purchase or sale of a definite amount of a specified shall be executed, *except 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;*

(2) No Change.

*Any exercise of time and price discretion must be reflected on the customer order ticket.*

\* \* \* \* \*

#### 3010. Supervision

(a) through (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* [the Rules of this Association]. 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 and at least an annual inspection of each office of supervisory jurisdiction. Each branch office of the member shall be inspected according to a cycle which shall be set forth in the firm's written supervisory and inspection procedures. In establishing such cycle, the firm shall give consideration to 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. Each member shall retain a written record of the dates upon which each review and inspection is conducted.

(2) *Office inspections by members pursuant to paragraph (c)(1) must be conducted by a person who is independent from the activities being performed at the office and those persons providing supervision to that office. The independence requirements in connection with office inspections may be satisfied by reasonable means based on the size and resources of the firm and the scope and nature of its activities. Written reports of these inspections are to be kept on file by the member for a minimum of three years.*

*An office inspection and review must include, but is not limited to, 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.*

(3) Pursuant to the Rule 9600 Series, NASD may exempt any member unconditionally or on specified terms and conditions from the independence requirement in the inspection of a member's offices as set forth in paragraph (c)(2) upon a satisfactory showing that complying with the requirements would be unduly burdensome on the member and that the member's internal inspection procedures are reasonably designed to achieve compliance with applicable securities laws and regulations and applicable NASD rules.

\* \* \* \* \*

#### 3012. Supervisory Controls

(a) General Requirements

(1) *Each member shall establish and maintain 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 member's supervisory controls must be performed by persons who are*

<sup>5</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

independent from those activities being tested and verified and the persons who directly supervise those activities. The independence requirements in connection with testing and verification may be satisfied by reasonable means based on the size and resources of the firm and the scope and nature of its activities. A report detailing each member's systems of supervisory controls, including a summary of the test results and significant identified exceptions, must be submitted no less than annually to the member's senior management.

(2) The independence requirement in the verification and testing of the member's supervisory procedures shall not apply to members that do not conduct a public business, or that have a capital requirement of \$5,000 or less, or that employ 10 or fewer registered representatives.

#### (b) Managers' Activities

Each member shall establish, maintain, and enforce written policies and procedures to administer the supervisory controls established pursuant to paragraph (a) reasonably designed to independently review and monitor the servicing of customer accounts by the member's branch office managers, sales managers, regional or district sales managers, or any person performing a similar supervisory function.

#### (c) Customers' Activities

Each member shall establish, maintain, and enforce written policies and procedures to administer the supervisory controls established pursuant to paragraph (a), specifically with respect to the following activities:

(1) Transmittals of funds (e.g., wires or checks, etc.) or securities:

(A) from customer accounts to third party accounts (i.e., a transmittal that would result in a change of beneficial ownership);

(B) from customer accounts to outside entities (e.g., banks, investment companies, etc.);

(C) from customer accounts to locations other than a customer's primary residence (e.g., post office, "in care of" accounts, alternate address, etc.); and

(D) between customers and registered representatives, including the hand-delivery of checks.

(2) Customer changes of address.

(3) Customer changes of investment objectives.

The policies and procedures established pursuant to paragraph (c) must include a means or method of

customer confirmation, notification, or follow-up that can be documented.

#### (d) 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.

\* \* \* \* \*

### 3110. Books and Records

(a) through (c) No change.

(d) *Changes in Account Name or Designation.*

Before any customer order is executed, there must be placed upon the memorandum for each transaction, the name or designation of the account (or accounts) for which such order is to be executed. No change in such account name(s) (including related accounts) or designation(s) (including error accounts) shall be made unless the change has been authorized by a member or a person(s) designated under the provisions of NASD rules. Such person must, prior to giving his or her approval of the account designation change, be personally informed of the essential facts relative thereto and indicate his or her approval of such change in writing on the order or other similar record of the member. The essential facts relied upon by the person approving the change must be documented in writing and maintained in a central location.

For purposes of this paragraph (d), a person(s) designated under the provisions of NASD rules to approve account name or designation changes must pass a qualifying principal examination appropriate to the business of the firm.

\* \* \* \* \*

### IM-3110. Customer Account Information

(a) through (h) No Change.

(i) *Holding of Customer Mail*

Upon the written instructions of a customer, a member may hold mail for a customer who will not be at his or her usual address for the period of his or her absence, but (A) not to exceed two months if the member is advised that such customer will be on vacation or traveling or (B) not to exceed three months if the customer is going abroad.

\* \* \* \* \*

### 9610. Application

(a) Where to File

A member seeking an exemption from Rule 1021, 1022, 1070, 2210, 2320, 2340, 2520, 2710, 2720, 2810, 2850, 2851, 2860, Interpretive Material 2860-1, 3010(b)(2), 3010(c), 3020, 3210, 3230,

3350, 8211, 8212, 8213, 11870, or 11900, Interpretive Material 2110-1, or Municipal Securities Rulemaking Board Rule G-37 shall file a written application with the appropriate department or staff of NASD [the Association] and provide a copy of the application to the Office of General Counsel of NASD [Regulation], *Regulatory Policy and Oversight*.

(b) through (c) No Change.

\* \* \* \* \*

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

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

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

#### 1. Purpose

Adequate supervisory systems play an important role in assuring investor protection and the integrity of the markets. Operational and sales practice abuses can stem from ineffective supervisory and supervisory control procedures. The recent Gruttadauria case, which involved the misappropriation of customer funds, has brought tremendous attention to the ongoing problem of operational and sales practice abuses at firms and the importance of ensuring that firms effectively monitor the activities of their employees.

NASD rules contain extensive supervisory requirements. NASD Rule 3010 generally requires each member to establish and maintain a supervisory system, including the development of written procedures. Beyond this broad general requirement, NASD Rule 2110 requires members to observe high standards of commercial honor and just and equitable principles of trade, and NASD Rule 3110 sets forth extensive books and records obligations. In addition, the NASD recently established comprehensive examination procedures for supervisory controls. The examination procedures focus on supervisory controls as they relate to several areas of a firm, including senior

management, internal audit and trading risk controls.

In light of the concerns raised by the Guttadauria case with respect to inadequate supervisory systems, the NASD is proposing a new rule and amendments to existing rules to enhance the NASD's current rules and examination efforts by specifically requiring members to establish adequate supervisory control systems. In general, proposed new NASD Rule 3012 sets forth general and specific supervisory control requirements while amendments to certain other rules complement NASD's efforts with new NASD Rule 3012. The New York Stock Exchange, Inc. ("NYSE") also recently filed with the SEC a series of amendments aimed at improving a firm's supervisory and internal (or supervisory) control systems.<sup>3</sup> The NASD states that its proposed rule change is substantially similar to the NYSE's proposed amendments.

The obligation to establish supervisory and supervisory control procedures is not a "one-size-fits-all" requirement. The NASD recognizes that there is no single set of procedures that will be appropriate for all firms and each firm must tailor such procedures to fit its business. In developing appropriate supervisory and supervisory control procedures, each firm must consider factors such as its size, location, and nature of business activities.

#### *Supervisory Controls—General Requirement*

Under NASD Rule 3010, a member's supervisory system is required to encompass the activities in which the member engages as well as the activities of the member's registered representatives and associated persons in order to achieve compliance with applicable securities laws and regulations and NASD rules. Not only must supervisory procedures be established, but such procedures must also be independently tested and verified through a system of supervisory control procedures to ensure appropriate application and effectiveness. The proposed rule change would require firms to develop and maintain a system of adequate supervisory control procedures that (1) 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 the

applicable securities laws and regulations, and with the applicable NASD rules and (2) create additional or amend supervisory procedures where the need is identified by such testing and verification.

The proposed rule change would require that a member's control procedures be performed by persons who are independent of the activities being tested and verified and the persons who directly supervise those activities. The independence requirement may be achieved by reasonable means in light of the member firm's size and resources and nature and scope of its activities. In practice, the NASD would expect that, unless a member could establish it was impractical, the system of supervisory controls will be deployed by persons who (1) are not connected in function to, or receive direct remuneration from, the activities which are the subject of the supervisory control procedures and (2) do not report to persons who supervise those activities. In the situation where the size and resources of the firm and the scope and nature of its activities make it impracticable for the firm to achieve independence in this fashion, the firm may satisfy the independence requirement by alternative means such as establishing additional policies and procedures to create a sufficient level of separation. Members would be required to report the testing and verification results to the firm's senior management annually.

Recognizing that the independence requirement in connection with testing and verification may not be practical for smaller members, the proposed rule change would allow an exemption from this independence requirement for firms that do not conduct a public business, or have a capital requirement of \$5,000 or less, or employ 10 or fewer registered representatives.

#### *Supervisory Controls—Customers' Activities*

The NASD believes that certain customer activities, such as the transmittal of customer funds or changes in customer address or investment objectives, require additional monitoring to help prevent fraud and theft of customer funds. Changes in customer investor objectives would require additional protections because of the importance of maintaining accurate books and records in the course of the member's business and potential for sales practice abuse in connection with the recording of inaccurate investment objectives for customers. The monitoring of customer address changes would guard against

the improper delivery of customer-related documentation. As such, the proposed rule change would require firms to establish written supervisory control procedures specifically with respect to the transmittal of customer funds and changes in customer address and investment objectives. Members would be required to follow-up with customers after the occurrence of any of these activities and to document the method of follow-up.

#### *Supervisory Controls—Sales Managers' Activities*

The proposed amendments would require firms to develop and implement written policies to independently review and monitor the servicing of customer accounts by branch office managers, sales managers, regional/district sales managers, and other supervisory personnel. The NASD expects that all sales-related activities will be reviewed. The NASD believes that the sales activities of branch managers and other sales managers should be subject to independent oversight to ensure that supervisors do not perform the final review of their own sales activity.

#### *Dual Members*

Proposed NASD Rule 3012 provides that a member that is in compliance with substantially similar requirements of the NYSE shall be deemed to be in compliance with the supervisory control requirements set forth in NASD Rule 3012.

#### *Office Inspection*

NASD Rule 3010(c) requires members to inspect and review the activities of each office.<sup>4</sup> To ensure that the inspections are objective and not subject to conflicts of interests, the proposed rule change would require that office inspections be conducted, by a person who is independent from the activities being performed at the office and the persons providing supervision to the office. Similar to the general supervisory controls amendments discussed earlier, the independence requirements may be satisfied by reasonable means based on the size and resources of the firm and the scope and nature of its activities. Office inspection programs would be required to include, at a minimum, testing and verification of a member's

<sup>3</sup> See Securities Exchange Act Release No. 46858 (November 20, 2002) (SR-NYSE-2002-36).

<sup>4</sup> NASD Rule 3010(c) requires an inspection at least annually of each office of supervisory jurisdiction and cycle examinations of branch offices. Although the rule does not specify the frequency of inspections for unregistered offices, NASD, Notice to Members 98-38 (May 1998) states that in order to fulfill the general obligation to supervise, such inspections should be conducted according to a regular schedule.

policies and procedures with respect to: (1) Safeguarding of customer funds and securities; (2) maintaining books and records; (3) supervision of customer accounts serviced by branch office managers; (4) transmittal of customer funds; (5) validation of customer address changes; and (6) validation of changes in customer account information.

The NASD recognizes that it may not be practical for members with small offices to conduct an independent inspection. In this regard, the proposed rule change would allow the NASD to exempt members pursuant to the NASD Rule 9600 Series from the independence requirement in the inspection of a member's office.

#### *Discretionary Authority*

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 or prior written approval by the member, but does not specify the duration of such discretionary authority. The proposed rule change would clarify that a firm's authority to exercise time and price discretion terminates at the end of the business day on which the customer granted such discretion, unless a signed authorization from the customer shows otherwise. The proposed rule change would further require any exercise of time or price discretion to be reflected on the order ticket.

#### *Changes in Customer Account Name or Designation*

Because changes in account names or designations in connection with order executions can be subject to abuse, the NASD believes that such changes should be approved by a qualified person and the basis for the change should be adequately documented. The proposed rule change would specify that no changes to the account name(s) or designation(s), including related accounts or error accounts may be made unless previously authorized by the person designated to approve such changes. Such designated person would be required to pass a qualifying principal examination appropriate to the business of the firm, such as the General Securities Sales Supervisor (Series 9/10) or General Securities Principal (Series 24). The designated person must document the essential facts relied upon in approving the changes and maintain the record in a central location.

#### *Customer Mail*

To prevent improper mail delivery if a customer is away from his or her regular address for an extended period of time, the proposed rule change would allow members to hold mail for a customer upon receiving written instructions from the customer, not to exceed two months if the customer is on vacation or traveling or three months if the customer is going abroad.

#### 2. Statutory Basis

The NASD believes that the proposed rule change is consistent with the provisions of section 15A(b)(6) of the Act,<sup>5</sup> which requires, among other things, that NASD's rules must 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 NASD believes that the proposed rule change is designed to accomplish these ends by requiring members to establish more extensive supervisory and supervisory control procedures to monitor customer account activities of its employees and thereby reduce the potential for customer fraud and theft.

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

The NASD 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, as amended.

#### *C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others*

Written comments were neither solicited nor received.

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

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

(A) by order approve such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

<sup>5</sup> 15 U.S.C. 78o-1(b)(6).

#### **IV. Solicitation of Comments**

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to the File No. SR-NASD-2002-162 and should be submitted by December 18, 2002.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>6</sup>

**Margaret H. McFarland,**  
Deputy Secretary.

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#### **SECURITIES AND EXCHANGE COMMISSION**

**[Release No. 34-46862; File No. SR-NASD-2002-129]**

#### **Self Regulatory Organizations; Order Granting Approval to Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to the Security Futures Risk Disclosure Statement**

November 20, 2002.

On September 25, 2002, the National Association of Securities Dealers, Inc. ("NASD") filed with the Securities and Exchange Commission ("Commission"), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and rule 19b-4 thereunder,<sup>2</sup> a proposed rule change relating to the Security Futures Risk Disclosure Statement. The proposed rule change was published for comment in the **Federal Register** on October 17, 2002.<sup>3</sup>

<sup>6</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Securities Exchange Act Release No. 46614 (October 7, 2002), 67 FR 64162.