

Notice to Members

JANUARY 2005

SUGGESTED ROUTING

Legal & Compliance
Operations
Registered Representatives
Senior Management
Trading

KEY TOPICS

Account Name/Designation Changes
Institutional Securities Activities
Rule 3012 (Supervisory Control Systems)
Rule 3110 (Books and Records)
Supervision
Supervisory Control Procedures

GUIDANCE

Supervisory Controls

Guidance Regarding the Application of the Supervisory Control Amendments to Members' Securities Activities, Including Members' Institutional Securities Activities

Executive Summary

On September 30, 2004, the Securities and Exchange Commission (SEC) approved the Supervisory Control Amendments in their final form.¹ Previously, on June 17, 2004, the SEC approved similar rule changes proposed by the New York Stock Exchange (NYSE) to enhance its members' supervisory and supervisory control systems (Internal Control Amendments).² NASD's Supervisory Control Amendments and the NYSE's Internal Control Amendments become effective on January 31, 2005. Although NASD and the NYSE (the SROs) have previously provided their respective members with general guidance regarding the application of the new rule changes,³ additional questions have been raised. Accordingly, the SROs are issuing this joint memorandum to address those issues. The joint memorandum is set forth in Attachment A. The relevant NASD rule text is set forth in Attachment B.

Questions/Further Information

Questions or comments concerning this *Notice* may be directed to Patricia Albrecht, Assistant General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8026.

Endnotes

- 1 Exchange Act Release No. 50477 (September 30, 2004), 69 F.R. 59972 (October 6, 2004) (SR-NASD-2004-116).
- 2 Exchange Act Release No. 49882 (June 17, 2004), 69 F.R. 35108 (June 23, 2004).
- 3 See *NYSE Information Memo 04-38* (July 25, 2004); *NASD Notice to Members 04-71* (October 2004). See also NASD Supervisory Control Amendments Phone-In Workshop Transcript (December 16, 2004), which is available on the NASD Web site at: www.nasd.com/web/groups/educ_progs/documents/education_phone_workshop/nasdw_012809.pdf.

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ATTACHMENT A

JOINT MEMORANDUM OF NASD AND THE NYSE

Background

Adequate supervisory systems play an important role in assuring investor protection and the integrity of the securities markets. Operational and sales practice abuses can stem from ineffective supervisory systems and supervisory control procedures. Several recent broker misappropriation cases have brought heightened attention to the potential for operational and sales practice abuses at firms, and to the corresponding need to ensure that firms effectively monitor the activities of their employees.

In light of these concerns, NASD and the NYSE proposed new rules and rule amendments intended to strengthen their memberships' supervisory systems. On June 17, 2004, the SEC approved the NYSE's proposed rule amendments;¹ the NASD's corresponding rule amendments were approved in final form on September 30, 2004.² The amendments become effective on January 31, 2005.

Although NASD and the NYSE have previously provided their respective members and member organizations with general guidance regarding the application of the new rule changes,³ additional issues have been raised that require further clarification. The following questions and answers address those issues.

NYSE Internal Control and NASD Supervisory Control Amendments – Joint Questions and Answers

Producing Managers – NYSE Rule 342.19 and NASD Rule 3012

1. Who is considered a “Producing Manager” for purposes of NYSE Rule 342.19 and NASD Rule 3012?

In general, a Producing Manager is a branch office manager, a sales manager, a regional or district sales manager, or any person who performs a similar supervisory function and who services customer accounts in a capacity requiring registration.

2. Does NYSE Rule 342.19 or NASD Rule 3012 distinguish between a Producing Manager who services retail accounts and a Producing Manager who services only “institutional accounts”?

No. Neither NYSE Rule 342.19 nor NASD Rule 3012 makes such a distinction. While the method of supervisory oversight and review may differ as a matter of firm policy depending on the type of business being conducted, the rules apply to Producing Managers regardless of the nature of the accounts they service.

3. Is there an exception from the requirements of NYSE Rule 342.19 or NASD Rule 3012 for Producing Managers who conduct a limited public business?

No. While the method of supervisory oversight may differ as a matter of firm policy, depending on the level of business being conducted, there is no “de minimis” exception to NYSE Rule 342.19 or NASD Rule 3012 for any person who is deemed a Producing Manager.⁴ For example, if a Branch Office Manager services only a few accounts on behalf of family and friends, that person is still considered to be a Producing Manager for purposes of NYSE Rule 342.19 and NASD Rule 3012.

4. If a registered person occasionally enters orders as an accommodation to a Producing Manager, would the person be subject to the supervision and review requirements prescribed by NYSE Rule 342.19 and NASD Rule 3012?

If a registered person occasionally engages in customer account activity in rare instances solely as an accommodation to a Producing Manager who is out of the office for a short duration (e.g., vacation, travel, illness, etc.), that person would not be deemed to be subject to the supervision and review requirements prescribed by NYSE Rule 342.19 or NASD Rule 3012.

Similarly, if a supervisory person (i.e., a branch office manager, a sales manager, a regional or district sales manager, or any person who performs a similar supervisory function) who does not service customer accounts occasionally enters orders as an accommodation to another registered person who is out of the office for a short duration, the supervisory person would not be subject to the supervision and review requirements prescribed by NYSE Rule 342.19 and NASD Rule 3012.

Whether such status is warranted, however, is a facts and circumstances question to be reasonably determined by the firm. Any sales activity of persons not deemed to be subject to the supervision and review requirements prescribed by Rules 342.19 and 3012 must still be appropriately supervised by another qualified person under the general supervisory requirements of NYSE Rule 342 and NASD Rule 3010.

5. Does customer account activity, as contemplated by NYSE Rule 342.19 and NASD Rule 3012, include stock lending or prime brokerage activity?

No. Neither stock lending activity nor the clearing, financing, or custody functions related to prime brokerage activity, by themselves, are the types of activities at which the rules are directed, though such activities remain subject to the general supervisory requirements of NYSE Rule 342 and NASD Rule 3010.

Application of Alternate Supervision Provision of NYSE Rule 342.19 to a Producing Manager Whose Reviewer Does Not Have a Definitive Link to the Producing Manager's Reviewer

6. NYSE Rule 342.19 requires that if a person designated to review a Producing Manager receives an override or other income derived from that Producing Manager's customer activity that represents more than 10% of the designated person's gross income derived from the member or member organization over the course of a rolling twelve-month period, the member or member organization must establish alternate senior or otherwise independent supervision of that Producing Manager to be conducted by a qualified person pursuant to NYSE Rule 342.13.

If no definitive link can be determined between the compensation of a person designated to supervise a Producing Manager and the Producing Manager's customer activity, is the 10% override provision applicable?

No. The 10% override provision is intended to identify and address arrangements where the independence of a Producing Manager's supervisor may be compromised by a conflict of interest. If no link between the supervisor's salary and the Producing Manager's production exists, there would be no conflict of the kind intended to be addressed by the rule. However, member organizations must use due diligence to determine the existence of any direct or indirect link between the production of Producing Managers and the compensation of their designated supervisors that might give rise to a conflict of interest and trigger the 10% provision.

Dual Members' Compliance with NASD/NYSE Requirements

NASD is clarifying that, in accordance with NASD Rule 3012(b), dual NASD/ NYSE members that comply with NYSE Rule 342.19 and its related interpretations will be considered to be in compliance with Rule 3012, so long as the member also complies with all of the provisions of NYSE Rule 342.19 and applies that rule to all of its securities activities.

Changes in Account Name or Designation – NYSE Rule 410 and NASD Rule 3110(d)

7. Does NYSE Rule 410 or NASD Rule 3110(d) require prior firm approval of all account designation changes?

No. Certain customer-controlled account designation changes would not be subject to the prior approval requirement of NYSE Rule 409 or NASD Rule 3110(d). For example, the following types of changes would not require prior approval by the firm under these rules: (1) allocations from a parent holding account to sub-accounts by an entity registered under Section 8 of the Investment Company Act of 1940; (2) allocations among sub-accounts by investment advisers registered under Section 203 of the Investment Advisers Act of 1940 ("Advisers Act") or registered with the appropriate state authority, as required by Section 203A of the Advisers Act; or (3) allocations in the context of a prime brokerage arrangement.

Customer Notice Under NYSE Rule 401 and NASD Rule 3012(a)(2)

8. Under NYSE Rule 401 and NASD Rule 3012(a)(2), what means would be considered sufficient to demonstrate compliance with the notification requirement?

The rules do not prescribe the means or method of customer notification. However, the rules do require “a means/method of customer confirmation, notification, or follow-up that can be documented.” Accordingly, any customer contact pursuant to this requirement must be memorialized and retained for review. Factors to be considered with respect to the documentation of customer contact would include the date of notification; the means/method of contact (e.g., telephone number, email address, etc.); the account(s) in question; whether there was a response from the customer; and, if so, a brief summary of the customer’s response and any follow-up action taken.

In the case of electronic transactions made by the customer or a customer’s legal representative or agent (e.g., a registered investment adviser or agent acting pursuant to legal written authorization) via secure electronic means that are subject solely to the customer’s control, it would be sufficient under NYSE Rule 401 and NASD Rule 3012 for the system itself, as part of its functions, to generate an electronic notification to the customer evidencing the completed transaction. Whatever the means/method of customer notification used, an informed determination must be made that any persons responsible for following up with a customer be independent of the customer’s registered representative and be subject to appropriate supervision.

9. Are securities transfers that are done through ACATS covered by the “customer notification” requirements of NYSE Rule 401 or NASD Rule 3012(a)(2)?

No. The “customer notification” requirements do not apply to transfers of customer account assets conducted through ACATS; such transfers are governed by NYSE Rule 412 (“Customer Account Transfer Contracts”) and corresponding NASD Rule 11870. However, it is noted that both NYSE Rule 412 and NASD Rule 11870 allow a customer to transfer a portion of his or her account assets outside of ACATS pursuant to “authorized alternate instructions,” such as Letters of Authorization (“LOAs”) transmitted to the carrying (i.e., delivering) organization. Any such “ex-ACATS” transfers are subject to the provisions of NYSE Rule 401 and NASD Rule 3012(a)(2).

Endnotes

- 1 Exchange Act Release No. 49882 (June 17, 2004), 69 F.R. 35108 (June 23, 2004).
- 2 Exchange Act Release No. 50477 (September 30, 2004), 69 F.R. 59972 (October 6, 2004) (SR-NASD-2004-116).
- 3 See *NYSE Information Memo 04-38* (July 25, 2004); *NASD Notice to Members 04-71* (October 2004). See also NASD Supervisory Control Amendments Phone-In Workshop Transcript (December 16, 2004), which is available at: www.nasd.com/web/groups/educ_progs/documents/education_phone_workshop/nasdw_012809.pdf.
- 4 See *NASD Notice to Members 04-71* (October 2004).

ATTACHMENT B

Relevant Rule Text

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 security 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. This limitation shall not apply to time and price discretion exercised in an institutional account, as defined in Rule 3110(c)(4), pursuant to valid Good-Till-Cancelled instructions issued on a "not-held" basis. Any exercise of time and price discretion must be reflected on the order ticket;

(2) No Change.

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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.

(8) Deleted.

(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, 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 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;

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- (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 directly or indirectly 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 has 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 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 the 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.

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(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:

(i) any location identified in a telephone directory line listing or on a business card or letterhead, which listing, card, or letterhead also sets forth the address and telephone number of the branch office or OSJ of the firm from which the person(s) conducting business at the non-branch locations are directly supervised;

(ii) any location referred to in a member advertisement, as this term is defined in Rule 2210, by its local telephone number and/or local post office box provided that such reference may not contain the address of the non-branch location and, further, that such reference also sets forth the address and telephone number of the branch office or OSJ of the firm from which the person(s) conducting business at the non-branch location are directly supervised; or

(iii) any location identified by address in a member's sales literature, as this term is defined in Rule 2210, provided that the sales literature also sets forth the address and telephone number of the branch office or OSJ of the firm from which the person(s) conducting business at the non-branch locations are directly supervised.

(iv) any location where a person conducts business on behalf of the member occasionally and exclusively by appointment for the convenience of customers, so long as each customer is provided with the address and telephone number of the branch office or OSJ of the firm from which the person conducting business at the non-branch location is directly supervised.

(2)(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.

(i) A person who is either senior to, or otherwise independent of, the producing manager must perform such supervisory reviews. For purposes of this Rule, an "otherwise independent" person: may not report either directly or indirectly to the producing manager under review; must be situated in an office other than the office of the producing manager; must not otherwise have supervisory responsibility over the activity being reviewed (including not being directly compensated based in whole or in part on the revenues accruing for those activities); and must alternate such review responsibility with another qualified person every two years or less.

(ii) If a member is so limited in size and resources that there is no qualified person senior to, or otherwise independent of, the producing manager to conduct the reviews pursuant to (i) above (e.g., a member has only one office or an insufficient number of qualified personnel who can conduct reviews on a two-year rotation), the reviews may be conducted by a principal who is sufficiently knowledgeable of the member's supervisory control procedures, provided that the reviews are in compliance with (i) to the extent practicable.

(iii) A member relying on (ii) above must document in its supervisory control procedures the factors used to determine that complete compliance with all of the provisions of (i) is not possible and that the required supervisory systems and procedures in place with respect to any producing manager comply with the provisions of (i) above to the extent practicable.

(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 to

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 box, "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 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 producing manager or the producing manager's office shall be attributed as revenue generated by the business units supervised by the producing 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.

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3110. Books and Records

(a) through (b) No change.

(c) Customer Account Information

(1) through (3) No change.

(4) For purposes of this Rule, Rule 2310, and Rule 2510 the term "institutional account" shall mean the account of:

(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 preserved for a period of not less than three years, the first two years in an easily accessible place, as the term "easily accessible place" is used in SEC Rule 17a-4.

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.

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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.