

August 4, 2003

Katherine A. England
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1001

**Re: File No. SR-NASD-2002-162 – Proposed Supervisory Control Amendments –
Amendment No. 1**

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed please find the above-numbered rule filing. Also enclosed is a 3-1/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register release.

If you have any questions, please contact Patricia Albrecht, Office of General Counsel, Regulatory Policy and Oversight, NASD, at (202) 728-8026; e-mail patricia.albrecht@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Barbara Z. Sweeney
Senior Vice President
and Corporate Secretary

Enclosures

File No. SR-NASD-2002-162
Consists of 68 Pages
August 4, 2003
Amendment No. 1

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C.

Form 19b-4

Proposed Rule Change

by

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Pursuant to Rule 19b-4 under the
Securities Exchange Act of 1934

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”), the National Association of Securities Dealers, Inc. (“NASD”) is filing with the Securities and Exchange Commission (“SEC” or “Commission”) Amendment No. 1 to SR-NASD 2002-162 to address the comment letters received by the SEC in response to the publication in the *Federal Register* of Notice of Filing of File No. SR-NASD-2002-162 (the “rule filing”), which proposed a rule change regarding the supervisory and supervisory control procedures of member firms.¹ Below is the text of the revised rule change. Additions are underlined; deletions are bracketed.

* * * * *

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 for orders effected with or for an institutional account, as defined in Rule 3110(c)(4), pursuant to valid Good-Till-Cancelled instructions issued on a “not-held” basis;

¹ SEC Release No. 34-46859 (Nov. 20, 2002), 67 Fed. Reg. 70990 (Nov. 27, 2002).

(2) No Change.

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

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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 [the Rules of this Association]. 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) Each member shall designate and specifically identify to the Association one or more principals who shall review the supervisory system, procedures, and inspections implemented by the member as required by this Rule and take or recommend to senior management appropriate action reasonably designed to achieve the member's compliance with applicable securities laws and regulations, and with the Rules of this Association.]

(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].

(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. [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.]

(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 [such cycle], the firm shall [give consideration to] 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. 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 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;

(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) 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). 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 income of 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.

* * * * *

(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).

(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.²

² NASD has filed with the Commission a separate proposed rule change to Rule 3010(g)(2) that addresses other situations where a location of a member may be considered a "branch office" and affects only the content of what is now being renumbered as paragraph (2)(A) of Rule 3010(g). See SR-NASD-2003-104. If the SEC approves the proposed rule change in No. SR-NASD-2003-104 prior to approving the rule change proposed in this filing, NASD will file an amendment to this proposal updating the rule language in the new Rule 3010(g)(2). Alternatively, if the SEC approves the proposed rule change in this rule filing prior to approving the proposed rule change in SR-NASD-2003-104, NASD will file an amendment to SR-NASD-2003-104 reflecting the changes set forth in this filing.

(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 by a person. A person who is senior to the producing manager must perform such supervisory reviews. However, if a member does not conduct a public business, or has a capital requirement of \$5,000 or less, or employs 10 or fewer representatives, and its business is conducted in manner

necessitated by a limitation of resources that includes fewer than two layers of supervisory personnel, a person in another office 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;

(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; 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 of 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.

(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.

* * * * *

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 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.

* * * * *

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), 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].

(b) through (c) No Change.

* * * * *

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

(a) The original proposed rule change was approved by the Board of Directors of NASD Regulation, Inc. at its meeting on September 25, 2002, which authorized the filing of the rule change with the SEC. Counsel for The Nasdaq Stock Market and NASD Dispute Resolution have been provided an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by NASD to its Subsidiaries. The NASD Board of Governors reviewed the proposed rule change at its meeting on September 26, 2002. No other action by NASD is necessary for the filing of the proposed rule change. Section 1(a)(ii) of Article VII of the NASD By-Laws permits the NASD Board of Governors to adopt NASD Rules and amendments without recourse to the membership for approval.

NASD will announce the effective date of the proposed rule change in a Notice to members to be published no later than 60 days following Commission approval. The effective date will be 180 days following the date of Commission approval.

(b) Questions regarding this rule filing may be directed to Patricia Albrecht, Assistant General Counsel, Office of General Counsel, Regulatory Policy and Oversight, NASD, at (202) 728-8026.

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

(a) Purpose

(i) Background

On November 4, 2002, NASD filed with the Commission proposed rule change SR-NASD-2002-162. The rule change proposed new NASD Rule 3012 to 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, the rule change proposed amendments to (1) NASD Rule 3010(c) to 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 to expand upon a members' supervisory and recordkeeping requirements with respect to changes in customer account name or designation in connection with order executions; (3) NASD IM-3110 to provide guidance regarding when a member may hold mail for a customer who will be absent for a period of time; (4) NASD Rule 2510(d) to clarify the time limit on time-and-price discretionary authority; and (5) NASD Rule 9610 to incorporate into NASD Procedural Rules the ability of members to request an exemption from amended NASD Rule 3010(c).

The Commission received 72 comment letters in response to the *Federal Register* publication of SR-NASD-2002-162.³ The comments submitted to the Commission are summarized and responded to by issue below. Additional proposed rule changes are also discussed below.

(ii) General Comments on the Rule Change

Many commenters stated that the effective enforcement of existing supervisory rules should be sufficient to protect investors.⁴ These commenters frequently added that they viewed the proposed rules as an overreaction to the Gruttadauria case, which involved a producing branch manager who misappropriated millions of dollars in customer funds over a 15-year period. 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.⁵

³ List of comment letters attached as Exhibit 2.

⁴ 1st Global, Inc., Stephen Batman, CEO (12/18/02); AIG Advisor Group, Inc., Bridget M. Gaughan, EVP (12/30/02); Cambridge Investment Research, Inc., Terry L. Lister, General Counsel (12/20/02); Charles Schwab & Co., Inc., Selwyn J. Noteliovitz, SVP (2/25/03); Clark/Bardes Financial Services, Inc., Kevin Ballou, President (3/17/03); Commonwealth Financial Network, Peter T. Wheeler, President (12/17/02); CUNA Brokerage Services, Inc., Marcia L. Martin, President (12/19/02); FFP Securities, Inc., Craig A. Junkins, President/CEO (12/18/02); First Allied Securities, Inc., Adam Antoniadis, President/COO (12/18/02); Invest Financial Corporation, Lynn R. Niedermeier, President/CEO (12/17/02); Investment Centers of America, Inc., Greg Gunderson, President (12/16/02); Lesko Securities, Inc., Charles Lesko, Jr., President (12/18/02); Mutual Service Corp., Dennis S. Kaminski, EVP/CAO (12/18/02); MWA Financial Services, Robert M. Roth, President (12/18/02); Princor Financial Services Corp., Minoo Spellerberg, Compliance Officer (12/16/02); Rhodes Securities, Inc., Sandra T. Masek, EVP/COO (12/17/02); Securities America, Inc., Bryan R. Hill, President (12/16/02); Securities Industry Association, Self-Regulation and Supervisory Practices Group, Christopher R. Franke, Chairman – Self-Regulation and Supervisory Practices Committee (12/18/02); Transamerica Financial Advisors, Inc., Sandy Brown, President/COO (12/16/02); United Planners' Financial Services of America, Thomas H. Oliver, President, CEO, (12/13/02); USAllianz Securities, Inc., Michael D. Burns, CCO (12/16/02); Waterstone Financial Group, Inc., Thomas A. Hopkins, Chairman, (12/16/02); World Group Securities, Inc., Leesa M. Easley, Chief Legal Officer (12/19/02).

⁵ *Id.*; see also Associated Securities Corp., Neal K. Nakagiri, President/CEO (12/19/02); AXA Advisors, John M. Lefferts, President (12/18/02); Cadaret, Grant & Co., Arthur F. Grant, President (12/17/02); Commonwealth Financial Network, Peter T. Wheeler, President (12/17/02); Equity Services, Inc., Gregory D. Teese, VP (12/18/02); Linsco/Private Ledger, Corp., James F. McGuire, SVP & CCO (1/16/03); National Society of Compliance Professionals, Inc., Joan Hinchman, Executive Director, President & CEO (1/8/03); Pacific Select Distributors, Inc., John L. Dixon, President (12/18/02).

While NASD understands industry concerns that regulators not overreact to one case of violative conduct, NASD does not view the proposed rule change as a reaction to any particular legal or regulatory event. Rather, NASD believes 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. NASD also believes that the proposed rule change will strengthen its ability to fulfill its ongoing obligation to protect investors.

A majority of the 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.⁶ Many commenters believed that this cost would destroy the business model of independent contractors located in small branch offices.⁷ One commenter suggested that the proposed rule

⁶ 1st Global, Inc., Stephen Batman, CEO (12/18/02); AIG Advisor Group, Inc., Bridget M. Gaughan, EVP (12/30/02); American Express Financial Advisors, Inc., Beth E. Weimer, VP & CCO (1/17/03); Cambridge Investment Research, Inc., Terry L. Lister, General Counsel (12/20/02); Clark/Bardes Financial Services, Inc., Kevin Ballou, President (3/17/03); CUNA Brokerage Services, Inc., Marcia L. Martin, President (12/19/02); Equity Services, Inc., Gregory D. Teese, VP (12/18/02); FFP Securities, Inc., Craig A. Junkins, President/CEO (12/18/02); Financial Network Investment Corp., Jack R. Handy, Jr., President (12/13/02); First Allied Securities, Inc., Adam Antoniadis, President/COO (12/18/02); IFG Network Securities, Inc., R. Jack Conley, President/CEO (12/18/02); Invest Financial Corporation, Lynn R. Niedermeier, President/CEO (12/17/02); Investment Centers of America, Inc., Greg Gunderson, President (12/16/02); John Hancock Financial Services, Inc., Robert H. Watts, SVP/CCO, (12/17/02) & Another Letter (1/16/03) (additional comments); Lesko Securities, Inc., Charles Lesko, Jr., President (12/18/02); Linsco/Private Ledger, Corp., James F. McGuire, SVP & CCO (1/16/03); Locust Street Securities, Inc., Jacqueline C. Conley, VP, Compliance (12/13/02); Multi-Financial Securities Corp., Patrick H. McEvoy, President/CEO (12/16/02); Mutual Service Corp., Dennis S. Kaminski, EVP/CAO (12/18/02); MWA Financial Services, Robert M. Roth, President (12/18/02); PrimeVest Financial Services, Inc., Kevin P. Maas, VP, (No Date on Letter); Princor Financial Services Corp., Minoo Spellerberg, Compliance Officer (12/16/02); Rhodes Securities, Inc., Sandra T. Masek, EVP/COO (12/17/02); Securities America, Inc., Bryan R. Hill, President (12/16/02); Transamerica Financial Advisors, Inc., Sandy Brown, President/COO (12/16/02); United Planners' Financial Services of America, CEO (12/13/02); USAllianz Securities, Inc., Michael D. Burns, CCO (12/16/02); Vestax Securities Corp., R. Jack Conley, President/CEO (12/17/02); Washington Square Securities, Inc., Tom K. Rippberger, VP/CCO (No Date on Letter); Waterstone Financial Group, Inc., Thomas A. Hopkins, Chairman, (12/16/02).

⁷ Associated Securities Corp., Neal K. Nakagiri, President/CEO (12/19/02); AXA Advisors, John M. Lefferts, President (12/18/02); Mutual Service Corp., Dennis S. Kaminski, EVP/CAO (12/18/02); Pacific Select Distributors, Inc., John L. Dixon, President (12/18/02); Securities Industry Association, Self-

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.⁸

NASD does not agree that the proposed rule change should be adopted in the form of “principles” or best practices.” NASD believes that the degree of authority carried by the proposed rules is necessary to encourage the conduct intended by the rule changes. However, as discussed in detail below, NASD agrees that greater flexibility is needed in certain respects to account for variations in members’ business models.

(iii) Comments on Proposed Rule 3012 (Supervisory Controls) and Proposed Changes

As originally proposed, Rule 3012 requires 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 testing and verification identifies the need to do so. Rule 3012 also requires 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.

In addition, Rule 3012 requires that written policies and procedures to administer the supervisory controls specifically address transmittals of funds between accounts, changes of customers’ addresses, and changes in customers’ investment objectives. These designated

Regulation and Supervisory Practices Group, Christopher R. Franke, Chairman – Self-Regulation and Supervisory Practices Committee (12/18/02); Woodbury Financial Services, Inc., Michael G. Brennan, Associate Counsel/Assistant Secretary (12/18/02).

⁸ 1st Global, Inc., Stephen Batman, CEO (12/18/02); Securities Industry Association, Self-Regulation and Supervisory Practices Group, Christopher R. Franke, Chairman – Self-Regulation and Supervisory Practices Committee (12/18/02).

policies and procedures must include a means or method of customer confirmation, notification, or follow-up that can be documented.

Many commenters requested clarification regarding who would be sufficiently “independent” to perform the supervisory control procedures required under proposed Rule 3012.⁹ A large number of commenters contended that restricting senior supervisory personnel from performing and/or overseeing the review of a firm’s supervisory control procedures could compromise the quality of the review. The 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.¹⁰

⁹ 1st Global, Inc., Stephen Batman, CEO (12/18/02); AIG Advisor Group, Inc., Bridget M. Gaughan, EVP (12/30/02); Cambridge Investment Research, Inc., Terry L. Lister, General Counsel (12/20/02); Charles Schwab & Co., Inc., Selwyn J. Noteliovitz, SVP (2/25/03); Clark/Bardes Financial Services, Inc., Kevin Ballou, President (3/17/03); Commonwealth Financial Network, Peter T. Wheeler, President (12/17/02); CUNA Brokerage Services, Inc., Marcia L. Martin, President (12/19/02); FFP Securities, Inc., Craig A. Junkins, President/CEO (12/18/02); First Allied Securities, Inc., Adam Antoniadis, President/COO (12/18/02); Invest Financial Corporation, Lynn R. Niedermeier, President/CEO (12/17/02); Investment Centers of America, Inc., Greg Gunderson, President (12/16/02); Lesko Securities, Inc., Charles Lesko, Jr., President (12/18/02); Midland National Life Insurance, P.M. Phalen, Assistant Vice President (12/17/02); MML Investors Services, Inc., Michael L. Kerley, VP/Chief Legal Officer (12/17/02); Mutual Service Corp., Dennis S. Kaminski, EVP/CAO (12/18/02); MWA Financial Services, Robert M. Roth, President (12/18/02); Prncor Financial Services Corp., Minoo Spellerberg, Compliance Officer (12/16/02); Rhodes Securities, Inc., Sandra T. Masek, EVP/COO (12/17/02); Securities America, Inc., Bryan R. Hill, President (12/16/02); Securities Industry Association, Self-Regulation and Supervisory Practices Group, Christopher R. Franke, Chairman – Self-Regulation and Supervisory Practices Committee (12/18/02); United Planners’ Financial Services of America, , President, CEO (12/13/02); USAllianz Securities, Inc., Michael D. Burns, CCO (12/16/02); Waterstone Financial Group, Inc., Thomas A. Hopkins, Chairman, (12/16/02); World Group Securities, Inc., Leesa M. Easley, Chief Legal Officer (12/19/02).

¹⁰ 21st Century Financial Services, Inc., Charles Mazziotti, President (12/17/02); AIG Advisor Group, Inc., Bridget M. Gaughan, EVP (12/30/02); Brookstreet Securities Corporation, Stanley C. Brooks, President, CEO (12/4/02); Cambridge Investment Research, Inc., Terry L. Lister, General Counsel (12/20/02); CUNA Brokerage Services, Inc., Marcia L. Martin, President (12/19/02); Duerr Financial Corporation, William Partin, President (11/27/02); Eagle One Investments, LLC, Steven J. Svoboda, President (12/16/02); Financial Network Investment Corp., Jack R. Handy, Jr., President (12/13/02); Financial Northeastern Companies, Dominick Del Duca, CCO (12/12/02); First Allied Securities, Inc., Adam Antoniadis, President/COO (12/18/02); First Heartland Capital, Inc., Julius J. Anderson, Vice President (12/27/02); FMN Capital Corporation, David W. Schofield, Director of Operations and Compliance (12/18/02); IFG Network Securities, Inc., R. Jack Conley, President/CEO (12/18/02); Invest Financial Corporation, Lynn R. Niedermeier, President/CEO (12/17/02); Investment Centers of America, Inc., Greg

At least one commenter stated that the “independence” requirement in Rule 3012 appears to refer to someone outside of the firm.¹¹

NASD agrees with commenters concerns and is amending proposed Rule 3012 to eliminate the requirement that persons conducting testing and verification procedures be “independent.” The proposed rule now will require that a member designate one or more principals who will establish supervisory control procedures that will test and verify that the members' supervisory procedures are sufficient and who will amend them when necessary. Of course, NASD 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. In addition, members must establish heightened supervisory procedures over the activities of each producing manager who is responsible for generating 20% or more of

Gunderson, President (12/16/02); Iron Street Securities Inc., Robert L. Hamman, President (12/24/02); JKR & Company, Inc., J. Kemp Richardson, President (12/10/02); John Hancock Financial Services, Inc., Robert H. Watts, SVP/CCO, (12/17/02) & Another Letter (1/16/03) (additional comments); Kyson & Co., Kao Sheng Lin, President (11/25/02); Lesko Securities, Inc., Charles Lesko, Jr., President (12/18/02); Liberty Life Securities, LLC, John T. Treece, President (1/15/03); Locust Street Securities, Inc., Jacqueline C. Conley, VP, Compliance (12/13/02); Main Street Securities, LLC, David L. Meckenstock, VP/CCO (12/13/02); Monitor Capital, Inc., Hsiao-wen, President (11/25/02); Multi-Financial Securities Corp., Patrick H. McEvoy, President/CEO (12/16/02); Mutual Securities, Inc., William L. Sabol, President (11/26/02); Mutual Service Corp., Dennis S. Kaminski, EVP/CAO (12/18/02); MWA Financial Services, Robert M. Roth, President (12/18/02); National Planning Corporation, M. Shawn Dreffein, President (12/2/02); Pacific West Securities, Inc., Philip A. Pizelo, President (1/14/03); PrimeVest Financial Services, Inc., Kevin P. Maas, VP, Director of Compliance (no date); Princor Financial Services Corp., Minoo Spellerberg, Compliance Officer (12/16/02); Quest Securities, Inc., Robert J. Schoen, President (11/22/02); Rhodes Securities, Inc., Sandra T. Masek, EVP/COO (12/17/02); Rhodes Securities, Inc., Sandra T. Masek, EVP/COO (12/17/02); Securities America, Inc., Bryan R. Hill, President (12/16/02); The Leaders Group, Inc., Z. Jane Riley, Compliance Officer (12/13/02); Transamerica Financial Advisors, Inc., Sandy Brown, President/COO (12/16/02); United Planners' Financial Services of America, Thomas H. Oliver, President/CEO (12/13/02); USAllianz Securities, Inc., Michael D. Burns, CCO (12/16/02); Vestax Securities Corp., R. Jack Conley, President/CEO (12/17/02); Washington Square Securities, Inc., Tom K. Rippberger, VP/CCO (no date on letter); Waterstone Financial Group, Inc., Thomas A. Hopkins, Chairman, (12/16/02); Wharton Equity Corp., Malcom A. Morrison, President (1/10/03); World Group Securities, Inc., Leesa M. Easley, Chief Legal Officer (12/19/02); World Trade Financial Corporation, Rod P. Michel, President (12/31/02).

¹¹ See Woodbury Financial Services, Inc., Michael G. Brennan, Associate Counsel/Assistant Secretary (12/18/02).

the income of the producing manager's supervisor. This proposed rule change should allow members sufficient flexibility to create supervisory control procedures without creating undue burdens and costs.

Several commenters mentioned that the requirements in proposed 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 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.¹²

NASD is aware of the similarity of the two supervisory review requirements. Accordingly, NASD is amending the proposed rule change to combine the two supervisory review requirements into proposed Rule 3012 and eliminate Rule 3010(a)(8) altogether.

One commenter stated that proposed Rule 3012's 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. An institutional exemption is sought because much of that business is done on a delivery-versus-payment or receipt-versus-payment basis or via prime brokerage arrangements that involve system and controls that are markedly different from

¹² Clark/Bardes Financial Services, Inc., Kevin Ballou, President (3/17/03); Financial Network Investment Corp., Jack R. Handy, Jr., President (12/13/02); Financial Northeastern Companies, Dominick Del Duca, CCO (12/12/02); IFG Network Securities, Inc., R. Jack Conley, President/CEO (12/18/02); Locust Street Securities, Inc., Jacqueline C. Conley, VP, Compliance (12/13/02); MML Investors Services, Inc., Michael L. Kerley, VP/Chief Legal Officer (12/17/02); Multi-Financial Securities Corp., Patrick H. McEvoy, President/CEO (12/16/02); PrimeVest Financial Services, Inc., Kevin P. Maas, VP, Director of Compliance (no date on letter); Vestax Securities Corp., R. Jack Conley, President/CEO (12/17/02); Washington Square Securities, Inc., Tom K. Rippberger, VP/CCO.

retail account servicing.¹³ NASD, however, believes that it is reasonable and appropriate that regulatory oversight in the sensitive areas designated in proposed Rule 3012 extend to institutional account activity.

(iv) Comments on Rule 3010 (Supervision) and Proposed Changes

As originally proposed, the changes to Rule 3010 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, office inspections must include, at a minimum, the testing and verification of certain specific supervisory procedures, including the transmission of customer funds and securities, changes in customers’ addresses, and changes in customers’ investment objectives.

Many commenters requested clarification regarding who would be sufficiently “independent” to conduct the office inspections required in Rule 3010.¹⁴ At least one commenter stated that the “independence” requirement in Rule 3010 appears to refer to someone within the

¹³ 1st Global, Inc., Stephen Batman, CEO (12/18/02); Securities Industry Association, Self-Regulation and Supervisory Practices Group, Christopher R. Franke, Chairman – Self-Regulation and Supervisory Practices Committee (12/18/02).

¹⁴ 1st Global, Inc., Stephen Batman, CEO; AIG Advisor Group, Inc., Bridget M. Gaughan, EVP (12/30/02); Cambridge Investment Research, Inc., Terry L. Lister, General Counsel (12/20/02); Charles Schwab & Co., Inc., Selwyn J. Noteliovitz, SVP (2/25/03); Clark/Bardes Financial Services, Inc., Kevin Ballou, President (3/17/03); Commonwealth Financial Network, Peter T. Wheeler, President (12/17/02); CUNA Brokerage Services, Inc., Marcia L. Martin, President (12/19/02); FFP Securities, Inc., Craig A. Junkins, President/CEO (12/18/02); First Allied Securities, Inc., Adam Antoniadis, President/COO (12/18/02); Invest Financial Corporation, Lynn R. Niedermeier, President/CEO (12/17/02); Investment Centers of America, Inc., Greg Gunderson, President (12/16/02); Lesko Securities, Inc., Charles Lesko, Jr., President (12/18/02); Midland National Life Insurance, P.M. Phalen, Assistant Vice President (12/17/02); MML Investors Services, Inc., Michael L. Kerley, VP/Chief Legal Officer (12/17/02); Mutual Service Corp., Dennis S. Kaminski, EVP/CAO (12/18/02); MWA Financial Services, Robert M. Roth, President (12/18/02); Princor Financial Services Corp., Minoo Spellerberg, Compliance Officer (12/16/02); Rhodes Securities, Inc., Sandra T. Masek, EVP/COO (12/17/02); Securities America, Inc., Bryan R. Hill, President (12/16/02); Securities Industry Association, Self-Regulation and Supervisory Practices Group, Christopher R. Franke, Chairman – Self-Regulation and Supervisory Practices Committee (12/18/02); United Planners’ Financial Services of America, Thomas H. Hill, President, CEO (12/13/02); USAllianz Securities, Inc., Michael D. Burns, CCO (12/16/02); Waterstone Financial Group, Inc., Thomas A.

firm who does not receive compensation based on sales.¹⁵ Many commenters stated that the “independence” requirement in 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.¹⁶ 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.¹⁷

Hopkins, Chairman, (12/16/02); World Group Securities, Inc., Leesa M. Easley, Chief Legal Officer (12/19/02).

¹⁵ See Woodbury Financial Services, Inc., Michael G. Brennan, Associate Counsel/Assistant Secretary (12/18/02).

¹⁶ 1st Global, Inc., Stephen Batman, CEO (12/18/02); AIG Advisor Group, Inc., Bridget M. Gaughan, EVP (12/30/02); American Express Financial Advisors, Inc., Beth E. Weimer, VP & CCO (1/17/03); Cambridge Investment Research, Inc., Terry L. Lister, General Counsel (12/20/02); Clark/Bardes Financial Services, Inc., Kevin Ballou, President (3/17/03); CUNA Brokerage Services, Inc., Marcia L. Martin, President (12/19/02); Equity Services, Inc., Gregory D. Teese, VP (12/18/02); FFP Securities, Inc., Craig A. Junkins, President/CEO (12/18/02); Financial Network Investment Corp., Jack R. Handy, Jr., President (12/13/02); First Allied Securities, Inc., Adam Antoniades, President/COO (12/18/02); IFG Network Securities, Inc., R. Jack Conley, President/CEO (12/18/02); Invest Financial Corporation, Lynn R. Niedermeier, President/CEO (12/17/02); Investment Centers of America, Inc., Greg Gunderson, President (12/16/02); John Hancock Financial Services, Inc., Robert H. Watts, SVP/CCO, (12/17/02); Lesko Securities, Inc., Charles Lesko, Jr., President (12/18/02); Linsco/Private Ledger, Corp., James F. McGuire, SVP & CCO (1/16/03); Locust Street Securities, Inc., Jacqueline C. Conley, VP, Compliance (12/13/02); Multi-Financial Securities Corp., Patrick H. McEvoy, President/CEO (12/16/02); Mutual Service Corp., Dennis S. Kaminski, EVP/CAO (12/18/02); MWA Financial Services, Robert M. Roth, President (12/18/02); PrimeVest Financial Services, Inc., Kevin P. Maas, VP, Director of Compliance (No Date on Letter); Princor Financial Services Corp., Minoo Spellerberg, Compliance Officer (12/16/02); Rhodes Securities, Inc., Sandra T. Masek, EVP/COO (12/17/02); Securities America, Inc., Bryan R. Hill, President (12/16/02); Transamerica Financial Advisors, Inc., Sandy Brown, President/COO (12/16/02); United Planners' Financial Services of America, Thomas H. Oliver, President/CEO (12/13/02); USAllianz Securities, Inc., Michael D. Burns, CCO (12/16/02); Vestax Securities Corp., R. Jack Conley, President/CEO (12/17/02); Washington Square Securities, Inc., Tom K. Rippberger, VP/CCO (No Date on Letter); Waterstone Financial Group, Inc., Thomas A. Hopkins, Chairman, (12/16/02).

¹⁷ 21st Century Financial Services, Inc., Charles Mazziotti, President (12/17/02); AIG Advisor Group, Inc., Bridget M. Gaughan, EVP (12/30/02); Brookstreet Securities Corporation, Stanley C. Brooks, President, CEO (12/4/02); Cambridge Investment Research, Inc., Terry L. Lister, General Counsel (12/20/02); Clark/Bardes Financial Services, Inc., Kevin Ballou, President (3/17/03); CUNA Brokerage Services, Inc., Marcia L. Martin, President (12/19/02); Duerr Financial Corporation, William Partin, President (11/27/02); Eagle One Investments, LLC, Steven J. Svoboda, President (12/16/02); FFP Securities, Inc., Craig A. Junkins, President/CEO (12/18/02); Financial Network Investment Corp., Jack R. Handy, Jr., President (12/13/02); First Allied Securities, Inc., Adam Antoniades, President/COO (12/18/02); First Heartland Capital, Inc., Julius J. Anderson, Vice President; (12/27/02); FMN Capital Corporation, David

In response to commenters' concerns, NASD is amending Rule 3010 to replace the proposed "independence" requirement with a prohibition 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). In addition, members must 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 supervisor's income. This proposed rule change should allow members sufficient flexibility to assign personnel to conduct office inspections without creating undue burdens and costs.

Because NASD has removed the "independence" requirement regarding inspections conducted pursuant to Rule 3010(c), NASD is removing the provision in Rule 3010(c) that would

W. Schofield, Director of Operations (12/18/02); IFG Network Securities, Inc., R. Jack Conley, President/CEO (12/18/02); Invest Financial Corporation, Lynn R. Niedermeier, President/CEO (12/17/02); Investment Centers of America, Inc., Greg Gunderson, President (12/16/02); Iron Street Securities Inc., Robert L. Hamman, President (12/24/02); JKR & Company, Inc., J. Kemp Richardson, President (12/10/02); Kyson & Co., Kao Sheng Lin, President (11/25/02); Lesko Securities, Inc., Charles Lesko, Jr., President (12/18/02); Liberty Life Securities, LLC, John T. Treece, President (1/15/03); Locust Street Securities, Inc., Jacqueline C. Conley, VP, Compliance (12/13/02); Main Street Securities, LLC, David L. Meckenstock, VP/CCO (12/13/02); Monitor Capital, Inc., Hsiao-wen, President (11/25/02); Multi-Financial Securities Corp., Patrick H. McEvoy, President/CEO (12/16/02); Mutual Securities, Inc., William L. Sabol, President (11/26/02); Mutual Service Corp., Dennis S. Kaminski, EVP/CAO (12/18/02); MWA Financial Services, Robert M. Roth, President (12/18/02); National Planning Corporation, M. Shawn Dreffein, President (12/2/02); Pacific West Securities, Inc., Philip A. Pizelo, President (1/14/03); PrimeVest Financial Services, Inc., Kevin P. Maas, VP, Director of Compliance (no date); Princor Financial Services Corp., Minoo Spellerberg, Compliance Officer (12/16/02); Quest Securities, Inc., Robert J. Schoen, President (11/22/02); Rhodes Securities, Inc., Sandra T. Masek, EVP/COO (12/17/02); Securities America, Inc., Bryan R. Hill, President (12/16/02); The Leaders Group, Inc., Z. Jane Riley, Compliance Officer and/CEO (12/13/02); Transamerica Financial Advisors, Inc., Sandy Brown, President/COO (12/16/02); United Planners' Financial Services of America, Thomas H. Oliver, President/CEO (12/13/02); USAllianz Securities, Inc., Michael D. Burns, CCO (12/16/02); Vestax Securities Corp., R. Jack Conley, President/CEO (12/17/02); Washington Square Securities, Inc., Tom K. Rippberger, VP/CCO (no date on letter); Waterstone Financial Group, Inc., Thomas A. Hopkins, Chairman, (12/16/02); Wharton Equity Corp., Malcom A. Morrison, President (1/10/03); World Group Securities, Inc., Leesa M. Easley, Chief Legal Officer (12/19/02); World Trade Financial Corporation, Rod P. Michel, President (12/31/02).

have allowed members to seek an exemption from the independence requirement in Rule 3010(c) subject to specified terms and conditions. NASD is also removing Rule 3010(c) from the list of rules in Rule 9610(a) from which a member can seek an exemption.

Many commenters argued that the current supervisory system, which allows Office of Supervisory Jurisdiction (“OSJ”) managers to conduct office inspections of branch and satellite offices should be retained because it was both effective and cost efficient.¹⁸ 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. In addition, OSJ managers’ auditing of branch and satellite offices serves to reinforce their accountability for the registered representatives’ actions.¹⁹

As stated previously, the proposed change to Rule 3010 has eliminated the proposed “independence” requirement with a prohibition 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 structure allows OSJ managers to conduct office inspections in any location where the OSJ manager is senior to the office’s branch manager. In addition, NASD is amending Rule 3010 to codify previous NASD guidance that non-supervisory branch offices be inspected every three years and that all non-branch locations be inspected periodically.²⁰

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *See NASD Notice to Members 98-38 (May 1998); NASD Notice to Members 99-45 (June 1999).*

(v) Comments on Changes to Rule 2510 (Discretionary Accounts) and Proposed Changes

As originally proposed, changes to Rule 2510(d)(1) require that time and price discretionary authority be limited to the day it is granted, absent written authorization to the contrary. Several commenters argued 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.²¹ Commenters argue that large orders for institutional accounts are “worked” over one or more days on a Good-Till-Cancelled/Not-Held basis.

NASD believes that a general institutional exemption is inappropriate. However, in response to commenters’ concerns, NASD is amending 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 Rule 3110(c)(4), that are exercised pursuant to valid Good-Till-Cancelled instructions issued on a “not held” basis. NASD is also making a technical amendment to Rule 3110(c)(4) to include a reference to the definition’s applicability to Rule 2510.

Commenters 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

²¹ A.G. Edwards & Sons, Inc., Brian C. Underwood, SVP (12/18/02); Charles Schwab & Co., Inc., Selwyn J. Noteliovitz, SVP (2/25/03); National Society of Compliance Professionals, Inc., Joan Ht & CEO (1/8/03); Securities Industry Association, Self-Regulation and Supervisory Practices Group, Christopher R. Franke, Chairman – Self-Regulation and Supervisory Practices Committee (12/18/02).

allows customers to issue general “standing” instructions, rather than issuing written instructions on an order-by-order basis.²²

The current text of 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” Any written authorization granting time and price discretion must comply with this established, trade-specific standard. Customers who wish to grant more extensive discretionary authority to their registered representatives may do so pursuant to a fully executed trading authorization.

(vi) Comments on Rule 3110 (Books and Records)

As originally proposed, changes to Rule 3110 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 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 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.²³

NASD understands the concerns that the proposed rule changes may place additional costs and burdens upon members. However, NASD believes that account names and designations

²² National Society of Compliance Professionals, Inc., Joan Hinchman, Executive Director, President & CEO (1/8/03); Securities Industry Association, Self-Regulation and Supervisory Practices Group, Christopher R. Franke, Chairman – Self-Regulation and Supervisory Practices Committee (12/18/02).

²³ Midland National Life Insurance, P.M. Phalen, Assistant Vice President (12/17/02).

are material information that must be protected from possible fraudulent activity. 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.²⁴

NASD 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. NASD 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.”²⁵

NASD does not believe that the new account designation change recordkeeping requirement should be unduly complicated or burdensome for members. Accordingly, NASD has 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. Specifically, the proposed rule change requires members to preserve account designation change documentation

²⁴ *Id.*

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 SEC Rule 17a-4. This proposed change will not only allow members to use existing recordkeeping systems to meet this requirement, but it will enable members to make the account designation change documentation promptly available if requested by NASD examination staff. It also coincides with Rule 3110’s existing mandate that members’ recordkeeping format, medium, and retention periods comply with SEC Rule 17a-4 requirements.

(vii) Comments on the Effective Date of the Rule Change

At least one commenter has requested that the effective date of any new requirements be delayed for 6 to 9 months after the approval date.²⁶ 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.

(viii) Comments on the Insufficient Comment Process

Many commenters criticized NASD for not publishing the proposed rule changes for comment prior to filing them with the SEC, stating that the initial comment period that followed the filing date was insufficient for everyone who wanted to comment to submit their comments in a timely manner. Commenters requested additional time to submit further comments on the proposed rule changes.²⁷

²⁵ See A.G. Edwards & Sons, Inc., Brian C. Underwood, SVP (12/18/02).

²⁶ Pacific Select Distributors, Inc., John L. Dixon, President (12/18/02).

²⁷ AIG Advisor Group, Inc., Bridget M. Gaughan, EVP (12/30/02); Commonwealth Financial Network, Peter T. Wheeler, President (12/17/02); CUNA Brokerage Services, Inc., Marcia L. Martin, President (12/19/02); FFP Securities, Inc., Craig A. Junkins, President/CEO (12/18/02); First Allied Securities, Inc., Adam Antoniadis, President/COO (12/18/02); Invest Financial Corporation, Lynn R. Niedermeier, President/CEO (12/17/02); Investment Centers of America, Inc., Greg Gunderson, President (12/16/02); Lesko Securities, Inc., Charles Lesko, Jr., President (12/18/02); Mutual Service Corp., Dennis S.

In response to earlier requests for additional time to submit comments on the proposed rule changes, the initial comment period was extended an additional 30 days. In addition, it is our understanding that the SEC will be publishing the new proposed rule changes for comment to allow concerned parties to submit their comments on the proposed changes described herein.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, 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. 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.

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

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.

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

The SEC received 72 written comment letters. NASD's response to those comment letters is discussed in section 3 above.

Kaminski, EVP/CAO (12/18/02); Pacific Select Distributors, Inc., John L. Dixon, President (12/18/02); Princi Financial Services Corp., Minoo Spellerberg, Compliance Officer (12/16/02); Rhodes Securities, Inc., Sandra T. Masek, EVP/COO (12/17/02); Securities America, Inc., Bryan R. Hill, President (12/16/02); Transamerica Financial Advisors, Inc., Sandy Brown, President/COO (12/16/02); United Planners' Financial Services of America, Thomas H. Oliver, President/CEO (12/13/02); USAllianz

6. Extension of Time Period for Commission Action

NASD does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Exhibits

1. Completed notice of proposed rule change for publication in the Federal Register.
2. Alphabetical list of comment letters.
3. Revised text of the proposed rule change marked to show the additions to and deletions from the immediately preceding filing.

Pursuant to the requirements of the Securities Exchange Act of 1934, NASD has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

NASD, INC.

BY: _____
Barbara Z. Sweeney, Senior Vice President and
Corporate Secretary

Date: August 4, 2003

Securities, Inc., Michael D. Burns, CCO (12/16/02); Waterstone Financial Group, Inc., Thomas A. Hopkins, Chairman, (12/16/02).

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-NASD-2002-162)

Self-Regulatory Organizations; Notice of Filing of Amendment No. 1 to Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Supervisory Control Amendments

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 , the National Association of Securities Dealers, Inc. (“NASD”), filed with the Securities and Exchange Commission (“SEC” or “Commission”) Amendment No. 1 to 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 to adopt new Rule 3012 and amend other rules regarding the supervisory and supervisory control procedures of member firms. Below is the revised text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

* * * * *

2510. Discretionary Accounts

(a) through (c) No change.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

(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 for orders effected with or for an institutional account, as defined in Rule 3110(c)(4), pursuant to valid Good-Till-Cancelled instructions issued on a “not-held” basis;

(2) No Change.

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

* * * * *

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 [the Rules of this Association]. 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) Each member shall designate and specifically identify to the Association one or more principals who shall review the supervisory system, procedures, and inspections

implemented by the member as required by this Rule and take or recommend to senior management appropriate action reasonably designed to achieve the member's compliance with applicable securities laws and regulations, and with the Rules of this Association.]

(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].

(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. [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.]

(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 [such cycle], the firm shall [give consideration to] 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. 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 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;

(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) 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). 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 income of 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.

* * * * *

(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).

(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

(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

³ NASD has filed with the Commission a separate proposed rule change to Rule 3010(g)(2) that addresses other situations where a location of a member may be considered a “branch office” and affects only the content of what is now being renumbered as paragraph (2)(A) of Rule 3010(g). See SR-NASD-2003-104. If the SEC approves the proposed rule change in No. SR-NASD-2003-104 prior to approving the rule change proposed in this filing, NASD will file an amendment to this proposal updating the rule language in the new Rule 3010(g)(2). Alternatively, if the SEC approves the proposed rule change in this rule filing prior to approving the proposed rule change in SR-NASD-2003-104, NASD will file an amendment to SR-NASD-2003-104 reflecting the changes set forth in this filing.

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 by a person. A person who is senior to the producing manager must perform such supervisory reviews. However, if a member does not conduct a public business, or has a capital requirement of \$5,000 or less, or employs 10 or fewer representatives, and its business is conducted in manner necessitated by a limitation of resources that includes fewer than two layers of supervisory personnel, a person in another office 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;

(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; 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 of 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.

(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.

* * * * *

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 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.

* * * * *

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), 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].

(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, 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. 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

(a) Purpose

(i) Background

On November 4, 2002, NASD filed with the Commission proposed rule change SR-NASD-2002-162. The rule change proposed new NASD Rule 3012 to 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, the rule change proposed amendments to (1) NASD Rule 3010(c) to 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 to expand upon a members' supervisory and recordkeeping requirements with respect to changes in customer account name or designation in connection with order executions; (3) NASD IM-3110 to provide guidance regarding when a member may hold mail for a customer who will be absent for a period of time; (4) NASD Rule 2510(d) to clarify the time limit on time-and-price discretionary authority; and (5) NASD Rule 9610 to incorporate into NASD Procedural Rules the ability of members to request an exemption from amended NASD Rule 3010(c).

The Commission received 72 comment letters in response to the *Federal Register* publication of SR-NASD-2002-162.⁴ The comments submitted to the Commission are

⁴ List of comment letters attached as Exhibit 2.

summarized and responded to by issue below. Additional proposed rule changes are also discussed below.

(ii) General Comments on the Rule Change

Many commenters stated that the effective enforcement of existing supervisory rules should be sufficient to protect investors.⁵ These commenters frequently added that they viewed the proposed rules as an overreaction to the Gruttadauria case, which involved a producing branch manager who misappropriated millions of dollars in customer funds over a 15-year period. 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.⁶

While NASD understands industry concerns that regulators not overreact to one case of violative conduct, NASD does not view the proposed rule change as a reaction to any particular legal or regulatory event. Rather, NASD believes that the proposed rule change is designed to

⁵ 1st Global, Inc., Stephen Batman, CEO (12/18/02); AIG Advisor Group, Inc., Bridget M. Gaughan, EVP (12/30/02); Cambridge Investment Research, Inc., Terry L. Lister, General Counsel (12/20/02); Charles Schwab & Co., Inc., Selwyn J. Noteliovitz, SVP (2/25/03); Clark/Bardes Financial Services, Inc., Kevin Ballou, President (3/17/03); Commonwealth Financial Network, Peter T. Wheeler, President (12/17/02); CUNA Brokerage Services, Inc., Marcia L. Martin, President (12/19/02); FFP Securities, Inc., Craig A. Junkins, President/CEO (12/18/02); First Allied Securities, Inc., Adam Antoniadis, President/COO (12/18/02); Invest Financial Corporation, Lynn R. Niedermeier, President/CEO (12/17/02); Investment Centers of America, Inc., Greg Gunderson, President (12/16/02); Lesko Securities, Inc., Charles Lesko, Jr., President (12/18/02); Mutual Service Corp., Dennis S. Kaminski, EVP/CAO (12/18/02); MWA Financial Services, Robert M. Roth, President (12/18/02); Princor Financial Services Corp., Minoo Spellerberg, Compliance Officer (12/16/02); Rhodes Securities, Inc., Sandra T. Masek, EVP/COO (12/17/02); Securities America, Inc., Bryan R. Hill, President (12/16/02); Securities Industry Association, Self-Regulation and Supervisory Practices Group, Christopher R. Franke, Chairman – Self-Regulation and Supervisory Practices Committee (12/18/02); Transamerica Financial Advisors, Inc., Sandy Brown, President/COO (12/16/02); United Planners' Financial Services of America, Thomas H. Oliver, President, CEO, (12/13/02); USAllianz Securities, Inc., Michael D. Burns, CCO (12/16/02); Waterstone Financial Group, Inc., Thomas A. Hopkins, Chairman, (12/16/02); World Group Securities, Inc., Leesa M. Easley, Chief Legal Officer (12/19/02).

⁶ *Id.*; see also Associated Securities Corp., Neal K. Nakagiri, President/CEO (12/19/02); AXA Advisors, John M. Lefferts, President (12/18/02); Cadaret, Grant & Co., Arthur F. Grant, President (12/17/02); Commonwealth Financial Network, Peter T. Wheeler, President (12/17/02); Equity Services, Inc., Gregory D. Teese, VP (12/18/02); Linsco/Private Ledger, Corp., James F. McGuire, SVP & CCO (1/16/03); National Society of Compliance Professionals, Inc., Joan Hinchman, Executive Director, President & CEO (1/8/03); Pacific Select Distributors, Inc., John L. Dixon, President (12/18/02).

enhance the current rules and examination efforts by specifically requiring members to establish adequate supervisory control systems. NASD also believes that the proposed rule change will strengthen its ability to fulfill its ongoing obligation to protect investors.

A majority of the 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.⁷ Many commenters believed that this cost would destroy the business model of independent contractors located in small branch offices.⁸ One commenter suggested that the proposed rule

⁷ 1st Global, Inc., Stephen Batman, CEO (12/18/02); AIG Advisor Group, Inc., Bridget M. Gaughan, EVP (12/30/02); American Express Financial Advisors, Inc., Beth E. Weimer, VP & CCO (1/17/03); Cambridge Investment Research, Inc., Terry L. Lister, General Counsel (12/20/02); Clark/Bardes Financial Services, Inc., Kevin Ballou, President (3/17/03); CUNA Brokerage Services, Inc., Marcia L. Martin, President (12/19/02); Equity Services, Inc., Gregory D. Teese, VP (12/18/02); FFP Securities, Inc., Craig A. Junkins, President/CEO (12/18/02); Financial Network Investment Corp., Jack R. Handy, Jr., President (12/13/02); First Allied Securities, Inc., Adam Antoniadis, President/COO (12/18/02); IFG Network Securities, Inc., R. Jack Conley, President/CEO (12/18/02); Invest Financial Corporation, Lynn R. Niedermeier, President/CEO (12/17/02); Investment Centers of America, Inc., Greg Gunderson, President (12/16/02); John Hancock Financial Services, Inc., Robert H. Watts, SVP/CCO, (12/17/02) & Another Letter (1/16/03) (additional comments); Lesko Securities, Inc., Charles Lesko, Jr., President (12/18/02); Linsco/Private Ledger, Corp., James F. McGuire, SVP & CCO (1/16/03); Locust Street Securities, Inc., Jacqueline C. Conley, VP, Compliance (12/13/02); Multi-Financial Securities Corp., Patrick H. McEvoy, President/CEO (12/16/02); Mutual Service Corp., Dennis S. Kaminski, EVP/CAO (12/18/02); MWA Financial Services, Robert M. Roth, President (12/18/02); PrimeVest Financial Services, Inc., Kevin P. Maas, VP, (No Date on Letter); Princor Financial Services Corp., Minoo Spellerberg, Compliance Officer (12/16/02); Rhodes Securities, Inc., Sandra T. Masek, EVP/COO (12/17/02); Securities America, Inc., Bryan R. Hill, President (12/16/02); Transamerica Financial Advisors, Inc., Sandy Brown, President/COO (12/16/02); United Planners' Financial Services of America, CEO (12/13/02); USAllianz Securities, Inc., Michael D. Burns, CCO (12/16/02); Vestax Securities Corp., R. Jack Conley, President/CEO (12/17/02); Washington Square Securities, Inc., Tom K. Rippberger, VP/CCO (No Date on Letter); Waterstone Financial Group, Inc., Thomas A. Hopkins, Chairman, (12/16/02).

⁸ Associated Securities Corp., Neal K. Nakagiri, President/CEO (12/19/02); AXA Advisors, John M. Lefferts, President (12/18/02); Mutual Service Corp., Dennis S. Kaminski, EVP/CAO (12/18/02); Pacific Select Distributors, Inc., John L. Dixon, President (12/18/02); Securities Industry Association, Self-Regulation and Supervisory Practices Group, Christopher R. Franke, Chairman – Self-Regulation and Supervisory Practices Committee (12/18/02); Woodbury Financial Services, Inc., Michael G. Brennan, Associate Counsel/Assistant Secretary (12/18/02).

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.⁹

NASD does not agree that the proposed rule change should be adopted in the form of “principles” or best practices.” NASD believes that the degree of authority carried by the proposed rules is necessary to encourage the conduct intended by the rule changes. However, as discussed in detail below, NASD agrees that greater flexibility is needed in certain respects to account for variations in members’ business models.

(iii) Comments on Proposed Rule 3012 (Supervisory Controls) and Proposed Changes

As originally proposed, Rule 3012 requires 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 testing and verification identifies the need to do so. Rule 3012 also requires 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.

In addition, Rule 3012 requires that written policies and procedures to administer the supervisory controls specifically address transmittals of funds between accounts, changes of customers’ addresses, and changes in customers’ investment objectives. These designated policies and procedures must include a means or method of customer confirmation, notification, or follow-up that can be documented.

⁹ 1st Global, Inc., Stephen Batman, CEO (12/18/02); Securities Industry Association, Self-Regulation and Supervisory Practices Group, Christopher R. Franke, Chairman – Self-Regulation and Supervisory Practices Committee (12/18/02).

Many commenters requested clarification regarding who would be sufficiently “independent” to perform the supervisory control procedures required under proposed Rule 3012.¹⁰ A large number of commenters contended that restricting senior supervisory personnel from performing and/or overseeing the review of a firm’s supervisory control procedures could compromise the quality of the review. The 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.¹¹

¹⁰ 1st Global, Inc., Stephen Batman, CEO (12/18/02); AIG Advisor Group, Inc., Bridget M. Gaughan, EVP (12/30/02); Cambridge Investment Research, Inc., Terry L. Lister, General Counsel (12/20/02); Charles Schwab & Co., Inc., Selwyn J. Noteliovitz, SVP (2/25/03); Clark/Bardes Financial Services, Inc., Kevin Ballou, President (3/17/03); Commonwealth Financial Network, Peter T. Wheeler, President (12/17/02); CUNA Brokerage Services, Inc., Marcia L. Martin, President (12/19/02); FFP Securities, Inc., Craig A. Junkins, President/CEO (12/18/02); First Allied Securities, Inc., Adam Antoniadis, President/COO (12/18/02); Invest Financial Corporation, Lynn R. Niedermeier, President/CEO (12/17/02); Investment Centers of America, Inc., Greg Gunderson, President (12/16/02); Lesko Securities, Inc., Charles Lesko, Jr., President (12/18/02); Midland National Life Insurance, P.M. Phalen, Assistant Vice President (12/17/02); MML Investors Services, Inc., Michael L. Kerley, VP/Chief Legal Officer (12/17/02); Mutual Service Corp., Dennis S. Kaminski, EVP/CAO (12/18/02); MWA Financial Services, Robert M. Roth, President (12/18/02); Prncor Financial Services Corp., Minoo Spellerberg, Compliance Officer (12/16/02); Rhodes Securities, Inc., Sandra T. Masek, EVP/COO (12/17/02); Securities America, Inc., Bryan R. Hill, President (12/16/02); Securities Industry Association, Self-Regulation and Supervisory Practices Group, Christopher R. Franke, Chairman – Self-Regulation and Supervisory Practices Committee (12/18/02); United Planners’ Financial Services of America, , President, CEO (12/13/02); USAllianz Securities, Inc., Michael D. Burns, CCO (12/16/02); Waterstone Financial Group, Inc., Thomas A. Hopkins, Chairman, (12/16/02); World Group Securities, Inc., Leesa M. Easley, Chief Legal Officer (12/19/02).

¹¹ 21st Century Financial Services, Inc., Charles Mazziotti, President (12/17/02); AIG Advisor Group, Inc., Bridget M. Gaughan, EVP (12/30/02); Brookstreet Securities Corporation, Stanley C. Brooks, President, CEO (12/4/02); Cambridge Investment Research, Inc., Terry L. Lister, General Counsel (12/20/02); CUNA Brokerage Services, Inc., Marcia L. Martin, President (12/19/02); Duerr Financial Corporation, William Partin, President (11/27/02); Eagle One Investments, LLC, Steven J. Svoboda, President (12/16/02); Financial Network Investment Corp., Jack R. Handy, Jr., President (12/13/02); Financial Northeastern Companies, Dominick Del Duca, CCO (12/12/02); First Allied Securities, Inc., Adam Antoniadis, President/COO (12/18/02); First Heartland Capital, Inc., Julius J. Anderson, Vice President (12/27/02); FMN Capital Corporation, David W. Schofield, Director of Operations and Compliance (12/18/02); IFG Network Securities, Inc., R. Jack Conley, President/CEO (12/18/02); Invest Financial Corporation, Lynn R. Niedermeier, President/CEO (12/17/02); Investment Centers of America, Inc., Greg Gunderson, President (12/16/02); Iron Street Securities Inc., Robert L. Hamman, President (12/24/02); JKR & Company, Inc., J. Kemp Richardson, President (12/10/02); John Hancock Financial Services, Inc., Robert H. Watts, SVP/CCO, (12/17/02) & Another Letter (1/16/03) (additional comments); Kyson & Co., Kao Sheng Lin, President (11/25/02); Lesko Securities, Inc., Charles Lesko, Jr., President (12/18/02); Liberty Life Securities, LLC, John T. Treece, President (1/15/03); Locust Street Securities, Inc.,

At least one commenter stated that the “independence” requirement in Rule 3012 appears to refer to someone outside of the firm.¹²

NASD agrees with commenters concerns and is amending proposed Rule 3012 to eliminate the requirement that persons conducting testing and verification procedures be “independent.” The proposed rule now will require that a member designate one or more principals who will establish supervisory control procedures that will test and verify that the members' supervisory procedures are sufficient and who will amend them when necessary. Of course, NASD 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. In addition, members must establish heightened supervisory procedures over the activities of each producing manager who is responsible for generating 20% or more of the income of the producing manager's supervisor. This proposed rule change should allow

Jacqueline C. Conley, VP, Compliance (12/13/02); Main Street Securities, LLC, David L. Meckenstock, VP/CCO (12/13/02); Monitor Capital, Inc., Hsiao-wen, President (11/25/02); Multi-Financial Securities Corp., Patrick H. McEvoy, President/CEO (12/16/02); Mutual Securities, Inc., William L. Sabol, President (11/26/02); Mutual Service Corp., Dennis S. Kaminski, EVP/CAO (12/18/02); MWA Financial Services, Robert M. Roth, President (12/18/02); National Planning Corporation, M. Shawn Dreffein, President (12/2/02); Pacific West Securities, Inc., Philip A. Pizelo, President (1/14/03); PrimeVest Financial Services, Inc., Kevin P. Maas, VP, Director of Compliance (no date); Princor Financial Services Corp., Minoo Spellerberg, Compliance Officer (12/16/02); Quest Securities, Inc., Robert J. Schoen, President (11/22/02); Rhodes Securities, Inc., Sandra T. Masek, EVP/COO (12/17/02); Rhodes Securities, Inc., Sandra T. Masek, EVP/COO (12/17/02); Securities America, Inc., Bryan R. Hill, President (12/16/02); The Leaders Group, Inc., Z. Jane Riley, Compliance Officer (12/13/02); Transamerica Financial Advisors, Inc., Sandy Brown, President/COO (12/16/02); United Planners' Financial Services of America, Thomas H. Oliver, President/CEO (12/13/02); USAllianz Securities, Inc., Michael D. Burns, CCO (12/16/02); Vestax Securities Corp., R. Jack Conley, President/CEO (12/17/02); Washington Square Securities, Inc., Tom K. Rippberger, VP/CCO (no date on letter); Waterstone Financial Group, Inc., Thomas A. Hopkins, Chairman, (12/16/02); Wharton Equity Corp., Malcom A. Morrison, President (1/10/03); World Group Securities, Inc., Leesa M. Easley, Chief Legal Officer (12/19/02); World Trade Financial Corporation, Rod P. Michel, President (12/31/02).

¹² See Woodbury Financial Services, Inc., Michael G. Brennan, Associate Counsel/Assistant Secretary (12/18/02).

members sufficient flexibility to create supervisory control procedures without creating undue burdens and costs.

Several commenters mentioned that the requirements in proposed 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 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.¹³

NASD is aware of the similarity of the two supervisory review requirements. Accordingly, NASD is amending the proposed rule change to combine the two supervisory review requirements into proposed Rule 3012 and eliminate Rule 3010(a)(8) altogether.

One commenter stated that proposed Rule 3012's 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. An institutional exemption is sought because much of that business is done on a delivery-versus-payment or receipt-versus-payment basis or via prime brokerage arrangements that involve system and controls that are markedly different from

¹³ Clark/Bardes Financial Services, Inc., Kevin Ballou, President (3/17/03); Financial Network Investment Corp., Jack R. Handy, Jr., President (12/13/02); Financial Northeastern Companies, Dominick Del Duca, CCO (12/12/02); IFG Network Securities, Inc., R. Jack Conley, President/CEO (12/18/02); Locust Street Securities, Inc., Jacqueline C. Conley, VP, Compliance (12/13/02); MML Investors Services, Inc., Michael L. Kerley, VP/Chief Legal Officer (12/17/02); Multi-Financial Securities Corp., Patrick H. McEvoy, President/CEO (12/16/02); PrimeVest Financial Services, Inc., Kevin P. Maas, VP, Director of Compliance (no date on letter); Vestax Securities Corp., R. Jack Conley, President/CEO (12/17/02); Washington Square Securities, Inc., Tom K. Rippberger, VP/CCO.

retail account servicing.¹⁴ NASD, however, believes that it is reasonable and appropriate that regulatory oversight in the sensitive areas designated in proposed Rule 3012 extend to institutional account activity.

(iv) Comments on Rule 3010 (Supervision) and Proposed Changes

As originally proposed, the changes to Rule 3010 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, office inspections must include, at a minimum, the testing and verification of certain specific supervisory procedures, including the transmission of customer funds and securities, changes in customers’ addresses, and changes in customers’ investment objectives.

Many commenters requested clarification regarding who would be sufficiently “independent” to conduct the office inspections required in Rule 3010.¹⁵ At least one commenter stated that the “independence” requirement in Rule 3010 appears to refer to someone within the

¹⁴ 1st Global, Inc., Stephen Batman, CEO (12/18/02); Securities Industry Association, Self-Regulation and Supervisory Practices Group, Christopher R. Franke, Chairman – Self-Regulation and Supervisory Practices Committee (12/18/02).

¹⁵ 1st Global, Inc., Stephen Batman, CEO; AIG Advisor Group, Inc., Bridget M. Gaughan, EVP (12/30/02); Cambridge Investment Research, Inc., Terry L. Lister, General Counsel (12/20/02); Charles Schwab & Co., Inc., Selwyn J. Noteliovitz, SVP (2/25/03); Clark/Bardes Financial Services, Inc., Kevin Ballou, President (3/17/03); Commonwealth Financial Network, Peter T. Wheeler, President (12/17/02); CUNA Brokerage Services, Inc., Marcia L. Martin, President (12/19/02); FFP Securities, Inc., Craig A. Junkins, President/CEO (12/18/02); First Allied Securities, Inc., Adam Antoniadis, President/COO (12/18/02); Invest Financial Corporation, Lynn R. Niedermeier, President/CEO (12/17/02); Investment Centers of America, Inc., Greg Gunderson, President (12/16/02); Lesko Securities, Inc., Charles Lesko, Jr., President (12/18/02); Midland National Life Insurance, P.M. Phalen, Assistant Vice President (12/17/02); MML Investors Services, Inc., Michael L. Kerley, VP/Chief Legal Officer (12/17/02); Mutual Service Corp., Dennis S. Kaminski, EVP/CAO (12/18/02); MWA Financial Services, Robert M. Roth, President (12/18/02); Princor Financial Services Corp., Minoo Spellerberg, Compliance Officer (12/16/02); Rhodes Securities, Inc., Sandra T. Masek, EVP/COO (12/17/02); Securities America, Inc., Bryan R. Hill, President (12/16/02); Securities Industry Association, Self-Regulation and Supervisory Practices Group, Christopher R. Franke, Chairman – Self-Regulation and Supervisory Practices Committee (12/18/02); United Planners’ Financial Services of America, Thomas H. Hill, President, CEO (12/13/02); USAllianz Securities, Inc., Michael D. Burns, CCO (12/16/02); Waterstone Financial Group, Inc., Thomas A.

firm who does not receive compensation based on sales.¹⁶ Many commenters stated that the “independence” requirement in 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.¹⁷ 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.¹⁸

Hopkins, Chairman, (12/16/02); World Group Securities, Inc., Leesa M. Easley, Chief Legal Officer (12/19/02).

¹⁶ See Woodbury Financial Services, Inc., Michael G. Brennan, Associate Counsel/Assistant Secretary (12/18/02).

¹⁷ 1st Global, Inc., Stephen Batman, CEO (12/18/02); AIG Advisor Group, Inc., Bridget M. Gaughan, EVP (12/30/02); American Express Financial Advisors, Inc., Beth E. Weimer, VP & CCO (1/17/03); Cambridge Investment Research, Inc., Terry L. Lister, General Counsel (12/20/02); Clark/Bardes Financial Services, Inc., Kevin Ballou, President (3/17/03); CUNA Brokerage Services, Inc., Marcia L. Martin, President (12/19/02); Equity Services, Inc., Gregory D. Teese, VP (12/18/02); FFP Securities, Inc., Craig A. Junkins, President/CEO (12/18/02); Financial Network Investment Corp., Jack R. Handy, Jr., President (12/13/02); First Allied Securities, Inc., Adam Antoniades, President/COO (12/18/02); IFG Network Securities, Inc., R. Jack Conley, President/CEO (12/18/02); Invest Financial Corporation, Lynn R. Niedermeier, President/CEO (12/17/02); Investment Centers of America, Inc., Greg Gunderson, President (12/16/02); John Hancock Financial Services, Inc., Robert H. Watts, SVP/CCO, (12/17/02); Lesko Securities, Inc., Charles Lesko, Jr., President (12/18/02); Linsco/Private Ledger, Corp., James F. McGuire, SVP & CCO (1/16/03); Locust Street Securities, Inc., Jacqueline C. Conley, VP, Compliance (12/13/02); Multi-Financial Securities Corp., Patrick H. McEvoy, President/CEO (12/16/02); Mutual Service Corp., Dennis S. Kaminski, EVP/CAO (12/18/02); MWA Financial Services, Robert M. Roth, President (12/18/02); PrimeVest Financial Services, Inc., Kevin P. Maas, VP, Director of Compliance (No Date on Letter); Princor Financial Services Corp., Minoo Spellerberg, Compliance Officer (12/16/02); Rhodes Securities, Inc., Sandra T. Masek, EVP/COO (12/17/02); Securities America, Inc., Bryan R. Hill, President (12/16/02); Transamerica Financial Advisors, Inc., Sandy Brown, President/COO (12/16/02); United Planners’ Financial Services of America, Thomas H. Oliver, President/CEO (12/13/02); USAllianz Securities, Inc., Michael D. Burns, CCO (12/16/02); Vestax Securities Corp., R. Jack Conley, President/CEO (12/17/02); Washington Square Securities, Inc., Tom K. Rippberger, VP/CCO (No Date on Letter); Waterstone Financial Group, Inc., Thomas A. Hopkins, Chairman, (12/16/02).

¹⁸ 21st Century Financial Services, Inc., Charles Mazziotti, President (12/17/02); AIG Advisor Group, Inc., Bridget M. Gaughan, EVP (12/30/02); Brookstreet Securities Corporation, Stanley C. Brooks, President, CEO (12/4/02); Cambridge Investment Research, Inc., Terry L. Lister, General Counsel (12/20/02); Clark/Bardes Financial Services, Inc., Kevin Ballou, President (3/17/03); CUNA Brokerage Services, Inc., Marcia L. Martin, President (12/19/02); Duerr Financial Corporation, William Partin, President (11/27/02); Eagle One Investments, LLC, Steven J. Svoboda, President (12/16/02); FFP Securities, Inc., Craig A. Junkins, President/CEO (12/18/02); Financial Network Investment Corp., Jack R. Handy, Jr., President (12/13/02); First Allied Securities, Inc., Adam Antoniades, President/COO (12/18/02); First Heartland Capital, Inc., Julius J. Anderson, Vice President; (12/27/02); FMN Capital Corporation, David

In response to commenters' concerns, NASD is amending Rule 3010 to replace the proposed "independence" requirement with a prohibition 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). In addition, members must 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 supervisor's income. This proposed rule change should allow members sufficient flexibility to assign personnel to conduct office inspections without creating undue burdens and costs.

Because NASD has removed the "independence" requirement regarding inspections conducted pursuant to Rule 3010(c), NASD is removing the provision in Rule 3010(c) that would

W. Schofield, Director of Operations (12/18/02); IFG Network Securities, Inc., R. Jack Conley, President/CEO (12/18/02); Invest Financial Corporation, Lynn R. Niedermeier, President/CEO (12/17/02); Investment Centers of America, Inc., Greg Gunderson, President (12/16/02); Iron Street Securities Inc., Robert L. Hamman, President (12/24/02); JKR & Company, Inc., J. Kemp Richardson, President (12/10/02); Kyson & Co., Kao Sheng Lin, President (11/25/02); Lesko Securities, Inc., Charles Lesko, Jr., President (12/18/02); Liberty Life Securities, LLC, John T. Treece, President (1/15/03); Locust Street Securities, Inc., Jacqueline C. Conley, VP, Compliance (12/13/02); Main Street Securities, LLC, David L. Meckenstock, VP/CCO (12/13/02); Monitor Capital, Inc., Hsiao-wen, President (11/25/02); Multi-Financial Securities Corp., Patrick H. McEvoy, President/CEO (12/16/02); Mutual Securities, Inc., William L. Sabol, President (11/26/02); Mutual Service Corp., Dennis S. Kaminski, EVP/CAO (12/18/02); MWA Financial Services, Robert M. Roth, President (12/18/02); National Planning Corporation, M. Shawn Dreffein, President (12/2/02); Pacific West Securities, Inc., Philip A. Pizelo, President (1/14/03); PrimeVest Financial Services, Inc., Kevin P. Maas, VP, Director of Compliance (no date); Princor Financial Services Corp., Minoo Spellerberg, Compliance Officer (12/16/02); Quest Securities, Inc., Robert J. Schoen, President (11/22/02); Rhodes Securities, Inc., Sandra T. Masek, EVP/COO (12/17/02); Securities America, Inc., Bryan R. Hill, President (12/16/02); The Leaders Group, Inc., Z. Jane Riley, Compliance Officer and/CEO (12/13/02); Transamerica Financial Advisors, Inc., Sandy Brown, President/COO (12/16/02); United Planners' Financial Services of America, Thomas H. Oliver, President/CEO (12/13/02); USAllianz Securities, Inc., Michael D. Burns, CCO (12/16/02); Vestax Securities Corp., R. Jack Conley, President/CEO (12/17/02); Washington Square Securities, Inc., Tom K. Rippberger, VP/CCO (no date on letter); Waterstone Financial Group, Inc., Thomas A. Hopkins, Chairman, (12/16/02); Wharton Equity Corp., Malcom A. Morrison, President (1/10/03); World Group Securities, Inc., Leesa M. Easley, Chief Legal Officer (12/19/02); World Trade Financial Corporation, Rod P. Michel, President (12/31/02).

have allowed members to seek an exemption from the independence requirement in Rule 3010(c) subject to specified terms and conditions. NASD is also removing Rule 3010(c) from the list of rules in Rule 9610(a) from which a member can seek an exemption.

Many commenters argued that the current supervisory system, which allows Office of Supervisory Jurisdiction (“OSJ”) managers to conduct office inspections of branch and satellite offices should be retained because it was both effective and cost efficient.¹⁹ 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. In addition, OSJ managers’ auditing of branch and satellite offices serves to reinforce their accountability for the registered representatives’ actions.²⁰

As stated previously, the proposed change to Rule 3010 has eliminated the proposed “independence” requirement with a prohibition 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 structure allows OSJ managers to conduct office inspections in any location where the OSJ manager is senior to the office’s branch manager. In addition, NASD is amending Rule 3010 to codify previous NASD guidance that non-supervisory branch offices be inspected every three years and that all non-branch locations be inspected periodically.²¹

¹⁹ *Id.*

²⁰ *Id.*

²¹ *See NASD Notice to Members 98-38 (May 1998); NASD Notice to Members 99-45 (June 1999).*

(v) Comments on Changes to Rule 2510 (Discretionary Accounts) and Proposed Changes

As originally proposed, changes to Rule 2510(d)(1) require that time and price discretionary authority be limited to the day it is granted, absent written authorization to the contrary. Several commenters argued 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.²² Commenters argue that large orders for institutional accounts are “worked” over one or more days on a Good-Till-Cancelled/Not-Held basis.

NASD believes that a general institutional exemption is inappropriate. However, in response to commenters’ concerns, NASD is amending 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 Rule 3110(c)(4), that are exercised pursuant to valid Good-Till-Cancelled instructions issued on a “not held” basis. NASD is also making a technical amendment to Rule 3110(c)(4) to include a reference to the definition’s applicability to Rule 2510.

Commenters 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

²² A.G. Edwards & Sons, Inc., Brian C. Underwood, SVP (12/18/02); Charles Schwab & Co., Inc., Selwyn J. Noteliovitz, SVP (2/25/03); National Society of Compliance Professionals, Inc., Joan Ht & CEO (1/8/03); Securities Industry Association, Self-Regulation and Supervisory Practices Group, Christopher R. Franke, Chairman – Self-Regulation and Supervisory Practices Committee (12/18/02).

allows customers to issue general “standing” instructions, rather than issuing written instructions on an order-by-order basis.²³

The current text of 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” Any written authorization granting time and price discretion must comply with this established, trade-specific standard. Customers who wish to grant more extensive discretionary authority to their registered representatives may do so pursuant to a fully executed trading authorization.

(vi) Comments on Rule 3110 (Books and Records)

As originally proposed, changes to Rule 3110 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 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 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.²⁴

NASD understands the concerns that the proposed rule changes may place additional costs and burdens upon members. However, NASD believes that account names and designations

²³ National Society of Compliance Professionals, Inc., Joan Hinchman, Executive Director, President & CEO (1/8/03); Securities Industry Association, Self-Regulation and Supervisory Practices Group, Christopher R. Franke, Chairman – Self-Regulation and Supervisory Practices Committee (12/18/02).

²⁴ Midland National Life Insurance, P.M. Phalen, Assistant Vice President (12/17/02).

are material information that must be protected from possible fraudulent activity. 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.²⁵

NASD 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. NASD 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.”²⁶

NASD does not believe that the new account designation change recordkeeping requirement should be unduly complicated or burdensome for members. Accordingly, NASD has 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. Specifically, the proposed rule change requires members to preserve account designation change documentation

²⁵ *Id.*

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 SEC Rule 17a-4. This proposed change will not only allow members to use existing recordkeeping systems to meet this requirement, but it will enable members to make the account designation change documentation promptly available if requested by NASD examination staff. It also coincides with Rule 3110’s existing mandate that members’ recordkeeping format, medium, and retention periods comply with SEC Rule 17a-4 requirements.

(vii) Comments on the Effective Date of the Rule Change

At least one commenter has requested that the effective date of any new requirements be delayed for 6 to 9 months after the approval date.²⁷ 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.

(viii) Comments on the Insufficient Comment Process

Many commenters criticized NASD for not publishing the proposed rule changes for comment prior to filing them with the SEC, stating that the initial comment period that followed the filing date was insufficient for everyone who wanted to comment to submit their comments in a timely manner. Commenters requested additional time to submit further comments on the proposed rule changes.²⁸

²⁶ See A.G. Edwards & Sons, Inc., Brian C. Underwood, SVP (12/18/02).

²⁷ Pacific Select Distributors, Inc., John L. Dixon, President (12/18/02).

²⁸ AIG Advisor Group, Inc., Bridget M. Gaughan, EVP (12/30/02); Commonwealth Financial Network, Peter T. Wheeler, President (12/17/02); CUNA Brokerage Services, Inc., Marcia L. Martin, President (12/19/02); FFP Securities, Inc., Craig A. Junkins, President/CEO (12/18/02); First Allied Securities, Inc., Adam Antoniadis, President/COO (12/18/02); Invest Financial Corporation, Lynn R. Niedermeier, President/CEO (12/17/02); Investment Centers of America, Inc., Greg Gunderson, President (12/16/02); Lesko Securities, Inc., Charles Lesko, Jr., President (12/18/02); Mutual Service Corp., Dennis S.

In response to earlier requests for additional time to submit comments on the proposed rule changes, the initial comment period was extended an additional 30 days. In addition, it is our understanding that the SEC will be publishing the new proposed rule changes for comment to allow concerned parties to submit their comments on the proposed changes described herein.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, 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. 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

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

The SEC received 72 written comment letters. NASD's response to those comment letters is discussed in section II above.

Kaminski, EVP/CAO (12/18/02); Pacific Select Distributors, Inc., John L. Dixon, President (12/18/02); Princor Financial Services Corp., Minoo Spellerberg, Compliance Officer (12/16/02); Rhodes Securities, Inc., Sandra T. Masek, EVP/COO (12/17/02); Securities America, Inc., Bryan R. Hill, President (12/16/02); Transamerica Financial Advisors, Inc., Sandy Brown, President/COO (12/16/02); United Planners' Financial Services of America, Thomas H. Oliver, President/CEO (12/13/02); USAllianz

III. DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION

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

- A. by order approve such proposed rule change, or
- B. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change [as amended] is consistent with the act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of NASD. All submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17 CFR 200.30-3(a)(12).

Margaret H. McFarland
Deputy Secretary

Comment Letters Relating to Supervisory Control Amendments
SR-NASD-2002-162--Alphabetized by Firm Name

1. 1st Global, Inc., Stephen Batman, Chief Executive Officer (12/18/02)
2. 21st Century Financial Services, Inc., Charles Mazziotti, President (12/17/02)
3. A.G. Edwards & Sons, Inc., Brian C. Underwood, SVP (12/18/02)
4. AIG Advisor Group, Inc., Bridget M. Gaughan, EVP (12/30/02)
5. American Express Financial Advisors, Inc., Beth E. Weimer, VP & CCO (1/17/03)
6. Associated Securities Corp., Neal K. Nakagiri, President/CEO (12/19/02)
7. AXA Advisors, John M. Lefferts, President (12/18/02)
8. Balanced Financial Securities, Martin Cohen, President (6/14/03)
9. BenefitsCorp Equities, Inc., Beverly A. Byrne, Secretary (12/18/02)
10. Brookstreet Securities Corporation, Stanley C. Brooks, President/CEO (12/4/02)
11. Cadaret Grant & Co., Inc., Arthur F. Grant, President (12/17/02)
12. Cambridge Investment Research, Inc., Terry L. Lister, General Counsel (12/20/02)
13. Charles Schwab & Co., Inc. Selwyn J. Notelwitz, SVP (2/25/03)
14. Clark/Bardes Financial Services, Inc., Kevin Ballou, President (3/17/03)
15. Commonwealth Financial Network, Peter T. Wheeler, President (12/17/02)
16. CUNA Brokerage Services, Inc., Marcia L. Martin, President (12/19/02)
17. Duerr Financial Corporation, William Partin, President (11/27/02)
18. Equity Services, Inc., Gregory D. Teese, VP (12/18/02)
19. Eagle One Investments, LLC, Steven J. Svoboda, President (12/16/02)
20. FFP Securities, Inc., Craig A. Junkins, President/CEO (12/18/02)
21. Financial Network Investment Corp., Jack R. Handy, Jr., President (12/13/02)
22. Financial Northeastern Companies, Dominick Del Duca, CCO (12/12/02)
23. First Allied Securities, Inc., Adam Antoniadis, President/COO (12/18/02)
24. First Heartland Capital, Inc., Julius J. Anderson, Vice President (12/27/02)
25. First Heartland Capital, Inc., David M. Hoff, President (12/27/02)
26. First Heartland Capital, Inc., Zeonia Christy, Compliance Officer (12/27/02)
27. FMN Capital Corporation, David W. Schofield, Director of Operations and Compliance (12/18/02)
28. IFG Network Securities, Inc., R. Jack Conley, President/CEO (12/18/02)
29. Invest Financial Corporation, Lynn R. Niedermeier, President/CEO (12/17/02)
30. Investment Centers of America, Inc., Greg Gunderson, President (12/16/02)
31. Iron Street Securities Inc., Robert L. Hamman, President (12/24/02)
32. JKR & Company, Inc., J. Kemp Richardson, President (12/10/02)
33. John Hancock Financial Services, Inc., Robert H. Watts, SVP/CCO, (12/17/02) & Another Letter (1/16/03) (additional comments)
34. Kyson & Co., Kao Sheng Lin, President (11/25/02)
35. Lesko Securities, Inc., Charles Lesko, Jr., President (12/18/02)
36. Liberty Life Securities, LLC, John T. Treece, President (1/15/03)
37. Linsco/Private Ledger, Corp., James F. McGuire, SVP & CCO (1/16/03)

38. Locust Street Securities, Inc., Jacqueline C. Conley, VP, Compliance (12/13/02)
39. Main Street Securities, LLC, David L. Meckenstock, VP/CCO (12/13/02)
40. Midland National Life Insurance Co., Paul M. Phalen, Asst. VP (12/17/02)
41. MML Investors Services, Inc., Michael L. Kerley, VP/Chief Legal Officer (12/17/02)
42. Monitor Capital, Inc., Hsiao-wen Kao, President (11/25/02)
43. Multi-Financial Securities Corp., Patrick H. McEvoy, President/CEO (12/16/02)
44. Mutual Securities, Inc., William L. Sabol, President (11/26/02)
45. Mutual Service Corp., Dennis S. Kaminski, EVP/CAO (12/18/02)
46. MWA Financial Services, Robert M. Roth, President (12/18/02)
47. National Association of Corporate Directors, Roger W. Raber, President/CEO (12/4/02)
48. National Society of Compliance Professionals, Inc., Joan Hinchman, Executive Director, President & CEO (1/8/03)
49. National Planning Corporation, M. Shawn Dreffein, President (12/2/02)
50. Pacific Select Distributors, Inc., John L. Dixon, President (12/13/02)
51. Pacific West Securities, Inc., Philip A. Pizelo, President (1/14/03)
52. PrimeVest Financial Services, Inc., Kevin P. Maas, VP, Director of Compliance (no date on letter)
53. Princor Financial Services Corp., Minoo Spellerberg, Compliance Officer (12/16/02)
54. Quest Securities, Inc., Robert J. Schoen, President (11/22/02)
55. Re-Direct Securities Corp., Andrew J. Powers, President & CCO, (12/13/02)
56. Rhodes Securities, Inc., Sandra T. Masek, EVP/COO (12/17/02)
57. Securities America, Inc., Bryan R. Hill, President (12/16/02)
58. Securities Industry Association, Self-Regulation and Supervisory Practices Group, Christopher R. Franke, Chairman – Self-Regulation and Supervisory Practices Committee (12/18/02)
59. Sonnenschein Nath Rosenthal, Nina S. McKenna (12/17/02)
60. The Leaders Group, Inc., Z. Jane Riley, Compliance Officer (12/13/02)
61. The Leaders Group, Inc., David R. Wickersham, President/CEO (12/13/02)
62. Transamerica Financial Advisors, Inc., Sandy Brown, President/COO (12/16/02)
63. United Planners' Financial Services of America, Thomas H. Oliver, President/ CEO (12/13/02)
64. USAllianz Securities, Inc., Michael D. Burns, CCO (12/16/02)
65. Vestax Securities Corp., R. Jack Conley, President/CEO (12/17/02)
66. Wall Street Financial Group, Inc., Victoria Bach-Fink, EVP (12/16/02)
67. Washington Square Securities, Inc., Tom K. Rippberger, VP/CCO (no date on letter)
68. Waterstone Financial Group, Inc., Thomas A. Hopkins, Chairman, (12/16/02)
69. Wharton Equity Corp., Malcom A. Morrison, President (1/10/03)
70. Woodbury Financial Services, Inc., Michael G. Brennan, Associate Counsel/Assistant Secretary (12/18/02)
71. World Group Securities, Inc., Leesa M. Easley, Chief Legal Officer (12/19/02)
72. World Trade Financial Corporation, Rod P. Michel, President (12/31/02)

Original Filing Additions are Underscored
Original Filing Deletions are [Bracketed]
Amendment No. 1 Additions are Double-Underscored
Amendment No. 1 Deletions are ~~Struck Through~~

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 for orders effected with or for an institutional account, as defined in Rule 3110(c)(4), pursuant to valid Good-Till-Cancelled instructions issued on a “not-held” basis;

(2) No Change.

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

* * * * *

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 ~~the Rules of this Association~~. 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) Each member shall designate and specifically identify to the Association one or more principals who shall review the supervisory system, procedures, and inspections implemented by the member as required by this Rule and take or recommend to senior management appropriate action reasonably designed to achieve the member's compliance with applicable securities laws and regulations, and with the Rules of this Association.~~

~~(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.~~

(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. ~~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.~~

(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 such cycle, the firm shall give consideration to 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. 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 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) 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 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, must include, but is not limited to,
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.

(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). 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 income of 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. Pursuant to the Rule 9600 Series, NASD may 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.

* * * * *

(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).

(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.¹

(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, ~~and~~ 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. ~~The member's~~

¹ NASD has filed with the Commission a separate proposed rule change to Rule 3010(g)(2) that addresses other situations where a location of a member may be considered a "branch office" and affects only the content of what is now being renumbered as paragraph (2)(A) of Rule 3010(g). See SR-NASD-2003-104. If the SEC approves the proposed rule change in No. SR-NASD-2003-104 prior to approving the rule change proposed in this filing, NASD will file an amendment to this proposal updating the rule language in the new Rule 3010(g)(2). Alternatively, if the SEC approves the proposed rule change in this rule filing prior to approving the proposed rule change in SR-NASD-2003-104, NASD will file an amendment to SR-NASD-2003-104 reflecting the changes set forth in this filing.

~~supervisory controls must be performed by persons who are 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. 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 by a person. A person who is senior to the producing manager must perform such supervisory reviews. However, if a member does not conduct a public business, or has a capital requirement of \$5,000 or less, or employs 10 or fewer representatives, and its business is conducted in manner necessitated by a limitation of resources that includes fewer than two layers of supervisory personnel, a person in another office 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;

(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; 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 of 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.

(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.~~

(b)(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.

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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 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.

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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.

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