

December 16, 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: SR-NASD-2002-162 - Supervisory Control Amendments - Amendment No. 3

Dear Ms. England:

NASD submits its response to comments received by the Securities and Exchange Commission ("SEC" or "Commission") on Amendments No. 1 and No. 2 to File No. SR-NASD-2002-162 (the "original rule filing" or "rule filing").¹ The rule filing proposed a rule change regarding the supervisory and supervisory control procedures of member firms. Amendments No. 1 and No. 2 (the "amendments to the original rule filing" or the "amendments") address the comment letters received by the SEC in response to the original rule filing and propose amendments responsive to the comments where appropriate.

Specifically, Amendments No. 1 and No. 2 eliminate the requirement in new NASD Rule 3012 that the persons performing the supervisory control system be independent from the activities being tested and verified and the persons who directly supervise those activities. Instead, the amendments to the original rule filing require only that one or more principals establish, maintain, and enforce a system of supervisory control policies and procedures that test and verify that the member's supervisory procedures are reasonably designed to comply with applicable securities laws and NASD rules and amend those supervisory procedures where necessary. The amendments modify new Rule 3012 to require that a person senior to the producing manager must perform the producing manager's supervisory reviews. The amendments also require heightened supervisory procedures for certain situations that involve a producing manager who is responsible for

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

generating 20% or more of the income of the producing manager's supervisor. In addition, the amendments to the original rule filing provide a limited exemption from the restrictions provided in Rules 3012 regarding who can perform supervisory reviews.

The amendments also eliminate the requirement in the original rule filing that under NASD Rule 3010(c) only independent persons can conduct office inspections. Instead, the amendments only restrict the branch office manager or any person within that office who has supervisory responsibilities or any individual who is supervised by such person(s) from conducting office inspections. The amendments require each member to inspect: (1) offices of supervisory jurisdiction and supervisory branch offices at least annually; (2) non-supervisory branch offices at least every three years; and (3) non-branch locations on a regular periodic schedule. The amendments also require heightened inspection procedures for certain situations that involve a producing manager who is responsible for generating 20% or more of the income of the producing manager's supervisor.

Additionally, the amendments require documentation in writing of the facts surrounding approvals of account name/designation changes performed pursuant to Rule 3110 and the documentation's preservation for at least three years, with the first two years in an easily accessible place, as the term "easily accessible place" is used in SEC Rule 17a-4. Finally, the amendments provide that the one-day limit on time and price discretionary authority in Rule 2510(d)(1) does not apply to time and price discretion exercised for orders effected with or for an institutional account pursuant to valid Good-Till-Cancelled instructions issued on a "not held" basis.

The amendments were published for comment in the *Federal Register* on August 13, 2003.² The comment period, which expired on October 3, 2003,³ generated 13 comment letters.⁴ A number of commenters generally agreed with the proposed

² SEC Release No. 34-48298 (August 7, 2003), 68 FR 48421 (August 13, 2003).

³ SEC Release No. 34-48460 (September 8, 2003), 68 FR 54034 (September 15, 2003).

⁴ American Council of Life Insurers, Carl B. Wilkerson, Chief Counsel, Securities & Litigation (September 3, 2003); American Council of Life Insurers, Carl B. Wilkerson, Chief Counsel, Securities & Litigation (October 3, 2003); Associated Securities Corp., Neal E. Nakagiri, President and CEO (October 2, 2003); Edward D. Jones and Co., LP, Pamela K. Cavness, Director of Compliance (October 2, 2003); Mass Mutual Financial Group, Robert S. Rosenthal, Second VP & Assoc. General Counsel (August 29, 2003); Monahan & Roth LLC, Lisa Roth, President (October 30, 2003); Mutual Service Corp., Dennis S. Kaminski, EVP/CAO (October 3, 2003); North American Securities Administrators Association, Inc., Ralph A. Lambiase, President and Director, Connecticut Division of Securities (October 24, 2003); Pace University School of Law, Barbara Black, Director, Jill I. Gross, Director, Jessica Longobardi, Student Intern (October 2, 2003); Pacific Select Distributors, S. Kendrick Dunn, Assist. VP (October 3, 2003); Securities Industry Association, John Polanin, Jr., Chairman, Self-Regulation and Supervisory Practices Committee (October 3, 2003); Sonnenschein, Nath & Rosenthal, LLP, Terry L. Lister, Of Counsel (September 30, 2003); United Planners' Financial Services of America, Julie Gebert, VP, Director of Compliance (October 3, 2003).

amendments.⁵ The commenters, however, also requested clarification on certain aspects of the amendments. NASD's response to the comment letters and additional proposed amendments are discussed below.⁶

Rule 3012 (Supervisory Control System)

The amendments to the original rule filing eliminate the originally proposed requirement in new Rule 3012 that the persons performing the supervisory control system be independent from the activities being tested and verified and the persons who directly supervise those activities. Instead, the amendments require that one or more principals establish, maintain, and enforce a system of supervisory control policies and procedures that test and verify that the member's supervisory procedures are reasonably designed to comply with applicable securities laws and NASD rules and amend those supervisory procedures where necessary. The amendments also modify new Rule 3012 to require that a person senior to the producing manager must perform the producing manager's supervisory reviews. In addition, the amendments require heightened supervisory procedures for certain situations that involve a producing manager who is responsible for generating 20% or more of the income of the producing manager's supervisor. Finally, the amendments to the original rule filing provide a limited exemption from the restrictions provided in Rules 3012 regarding who can perform supervisory reviews.

A. The term "senior," as used in Rule 3012 artificially narrows the scope of persons qualified to conduct a producing manager's review.

COMMENTS: One commenter stated that NASD should not limit the scope of persons qualified to conduct a producing manager's review under Rule 3012 only to those individuals who are "senior" to the producing manager.⁷ The commenter argued that other

⁵ Associated Securities Corp., Neal E. Nakagiri, President and CEO (October 2, 2003); Edward D. Jones and Co., LP, Pamela K. Cavness, Director of Compliance (October 2, 2003); North American Securities Administrators Association, Inc., Ralph A. Lambiase, President and Director, Connecticut Division of Securities (October 24, 2003); Pacific Select Distributors, S. Kendrick Dunn, Assist. VP (October 3, 2003); Securities Industry Association, John Polanin, Jr., Chairman, Self-Regulation and Supervisory Practices Committee (October 3, 2003); Mass Mutual Financial Group, Robert S. Rosenthal, Second VP & Assoc. General Counsel (August 29, 2003); Pace University School of Law, Barbara Black, Director, Jill I. Gross, Director, Jessica Longobardi, Student Intern (October 2, 2003).

⁶ One commenter requested assurance that its current supervisory and inspection procedures complied with NASD's supervisory control amendments. See Edward D. Jones and Co., LP, Pamela K. Cavness, Director of Compliance (October 2, 2003). NASD views this letter as a request for interpretive guidance. The rulemaking process is not the appropriate forum for interpretive relief. NASD suggests that if the commenter wants individualized clarification on the supervisory control amendments once the rules have become effective, the commenter should contact NASD through NASD's formal interpretive letter process.

⁷ Securities Industry Association, John Polanin, Jr., Chairman, Self-Regulation and Supervisory Practices Committee (October 3, 2003).

persons within a branch office or within a firm who are not senior to the producing branch office manager should be allowed to review the producing manager, as long as that person is of an equal level of “seniority” and has the requisite knowledge to conduct a meaningful review.

RESPONSE: NASD understands the concern that members may have to make changes to their supervisory review procedures to comply with this seniority requirement. NASD believes, however, that requiring the producing manager’s reviewer to be senior to the producing manager is essential to protecting investors and helping to ensure that events, such as the Gruttadauria case, which involved a producing branch manager who misappropriated millions of dollars in customer funds over a 15-year period and who supervised the compliance officer who reviewed him, do not occur again. NASD notes that the determination of seniority is a facts and circumstances test. For the purposes of supervision, a person who does not report to the producing manager, whose compensation is not determined in whole or part by the producing manager and who may not be in the same chain of line authority, may be senior for the purposes of supervision if that person has the authority to oversee, direct and correct the activities of the producing manager and take all necessary remedial actions, including termination, if and when necessary.

NASD has proposed a limited exception from the seniority requirement for members who: (1) do not conduct a public business; (2) have a capital requirement of \$5,000 or less; or (3) employ 10 or fewer employees; and, in the case of (1) through (3), have fewer than two layers of review. If a member fits this criteria, 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 does not have supervisory authority over the activity being reviewed, reports to his supervisor his supervision and review, and has not performed a review of the producing manager in the last two years.

NASD also understands that a member may be so limited in both size and resources that the member’s business model and/or number of associated persons prevent it from being able to meet this exception outlined above. Examples of such a member would include a member with only one office or a member with two offices and an insufficient number of qualified personnel who can conduct reviews on a two-year rotation. The only person a member would have available to conduct a producing manager’s review is someone within the producing manager’s office or someone in the member’s only other office. Accordingly, in such situations, members may have that person conduct the reviews required by Rule 3012 as long as that person is a principal who is sufficiently knowledgeable of the member’s supervisory control procedures. Members, however, must document their basis for relying on this exception.

Therefore, Rule 3012(a)(2)(A) beginning on pages eight and thirty-five should be revised to read as follows (new language is underlined and deleted text is [bracketed]):

(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 (i)⁸ does not conduct a public business, (ii) or has a capital requirement of \$5,000 or less, or (iii) employs 10 or fewer representatives, and, in the case of (i) through (iii), its business is conducted in a manner necessitated by a limitation of resources that includes fewer than two layers of supervisory personnel, a person in another office of the member who is in the same or similar position to the producing manager may conduct the supervisory reviews, provided that the person in the same or similar position does not have supervisory responsibility over the activity being reviewed, reports to his supervisor his supervision and review of the producing manager, and has not performed a review of the producing manager in the last two years. If a member is so limited in size and resources that it cannot avail itself of this exception (e.g., a member with only one office or a member with two offices and an insufficient number of qualified personnel who can conduct reviews on a two-year rotation), a member may have a principal who is sufficiently knowledgeable of the member's supervisory control procedures conduct these reviews. The member, however, must document in its supervisory control procedures the factors it has relied upon in determining that its size and the resources available to it are so limited that the member has no other alternative than to comply in this manner.

B. Can a member comply with the requirement in Rule 3012 to notify customers with respect to changes of address and investment objectives and validation of such changes if the member follows the SEC's books and records requirements?

COMMENTS: One commenter requested clarification regarding whether a member could comply with Rule 3012, with respect to changes of customer address and investment objectives and validation of such changes, if the member follows the procedures set forth in SEC Rule 17a-3(a)(17)(i).⁹

RESPONSE: Rule 3012(a)(2)(B) requires members to have in place supervisory control policies and procedures that include procedures that are reasonably designed to review and monitor all transmittals of customer funds and securities, and customer address and investment objectives changes and the validation of such changes. Rule 3012(a)(2)(B) was

⁸ The roman numeral references are being added for additional clarification.

⁹ Sonnenschein, Nath & Rosenthal, LLP, Terry L. Lister, of Counsel (September 30, 2003).

not designed to address the specific measures a member should adopt regarding the supervision of changes in a customer's address or investment objectives. Additionally, compliance with SEC Rule 17a-3(a)(17)(i)'s recordkeeping provisions may not be sufficient under all facts and circumstances to discharge a firm's supervisory requirements under Rule 3012(a)(2)(B). To avoid potential problems, members should ensure that they comply with both Rule 3012(a)(2)(B) and SEC Rule 17a-3(a)(17)(i).

C. Proposed Rule 3012(b) (Dual Members) should be deleted.

COMMENTS: One commenter requested that NASD delete Rule 3012's provision allowing a "dual" NASD/New York Stock Exchange ("NYSE") member to satisfy Rule 3012's requirements if the member satisfies substantially similar requirements promulgated by the NYSE.¹⁰ The commenter argues that Rule 3012 is more specific and detailed than comparable supervisory control requirements proposed by the NYSE.

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

Rule 3010 and Rule 3012

A. 20% Threshold for Heightened Supervisory Requirements

Rule 3010 requires a member to 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.

Rule 3012 requires a member to have 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.

¹⁰ Pace University School of Law, Barbara Black, Director, Jill I. Gross, Director, Jessica Longobardi, Student Intern (October 2, 2003).

COMMENTS: Several commenters requested clarification regarding the 20% threshold in Rules 3010 and 3012.¹¹ Specifically, commenters identified three concerns regarding the threshold: (1) how to structure compensation; (2) what time period to use to calculate the 20% threshold; and (3) whether the 20% threshold can be viewed as a “safe harbor.” In addition, one commenter asked for clarification regarding who is considered to be the producing manager’s supervisor if the producing manager is supervised directly by the member’s compliance department.¹²

RESPONSE: NASD agrees that further clarification is needed and is amending Rule 3010 and Rule 3012 to address the commenters’ concerns regarding compensation structure and time periods for calculation. Accordingly, NASD is replacing the 20% threshold of income of the producing manager’s supervisor with a threshold of 20% of the revenue of the business units supervised by the producing manager’s supervisor. For purposes of determining the 20% revenue threshold, all revenue generated by or credited to the producing manager or the producing manager’s office shall be attributed as revenue generated by the business unit or units supervised by the producing manager’s supervisor irrespective of the internal allocation of such revenue by the member. Additionally, the 20% threshold is to be calculated on a rolling, twelve-month basis.

Therefore, Rule 3010(c)(3) beginning on pages five and thirty-three should be revised to read as follows (new language is underlined and deleted text is [bracketed]):

(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 revenue [income] of the business units supervised by the branch office manager’s supervisor. For the purposes of this subsection only, the term “heightened inspection” shall mean those inspection procedures that are designed to avoid conflicts of interest that serve to undermine complete and effective inspection because of the economic, commercial, or financial interests that the branch manager’s supervisor holds in the associated persons and businesses being

¹¹ American Council of Life Insurers, Carl B. Wilkerson, Chief Counsel, Securities & Litigation (October 3, 2003); Associated Securities Corp., Neal E. Nakagiri, President and CEO (October 2, 2003); Pacific Select Distributors, S. Kendrick Dunn, Assist. VP (October 3, 2003); Securities Industry Association, John Polanin, Jr., Chairman, Self-Regulation and Supervisory Practices Committee (October 3, 2003); Sonnenschein, Nath & Rosenthal, LLP, Terry L. Lister, Of Counsel (September 30, 2003); United Planners’ Financial Services of America, Julie Gebert, VP, Director of Compliance (October 3, 2003).

¹² Sonnenschein, Nath & Rosenthal, LLP, Terry L. Lister, Of Counsel (September 30, 2003).

inspected. In addition, for the purpose of this section only, when calculating the 20% threshold, all of the revenue generated by or credited to the branch office or the branch office manager shall be attributed as revenue generated by the business units supervised by the branch office manager's supervisor irrespective of a member's internal allocation of such revenue. A member must calculate the 20% threshold on a rolling, twelve-month basis.

Rule 3012(a)(2)(C) beginning on pages nine and thirty-six should be revised to read as follows (new language is underlined and deleted text is [bracketed]):

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

Also, if a producing manager does not have an individual assigned to supervise him, but rather, is supervised directly by the member's compliance department, then the revenue produced would be attributable to a business unit supervised by the compliance department. If such revenue constitutes 20% or more of all of the supervised revenue attributable to the compliance department, then the member must have in place heightened inspection and supervisory procedures.

Finally, NASD does not view the 20% threshold as a "safe harbor," but rather, as a trigger for determining when a member must put in place heightened inspection and/or supervisory procedures.

B. The Requirement to Include Supervisory Procedures for Activities that Certain Broker/Dealers do not Conduct

Rule 3010 requires that a written inspection report include, without limitation, the testing and verification of the member's policies and procedures, including supervisory policies and procedures in the areas of safeguarding of customer funds and securities;

maintaining books and records; supervision of customer accounts serviced by branch office managers; transmittals of funds between customers and registered representatives and between customers and third parties; validation of customer address changes; and validation of changes in customer account information.

Rule 3012 requires the establishment, maintenance, and enforcement of written supervisory control policies and procedures that include procedures that are reasonably designed to review and monitor the transmittals of funds from customer accounts to locations other than a customer's primary residence and between customers and registered representatives, customer changes of address and validation of such changes of address; and customer changes of investment objectives and the validation of such changes of investment objectives.

COMMENTS: One commenter asked whether broker/dealers that did not engage in any or all of these activities, such as introducing broker/dealers or limited-purpose broker/dealers affiliated with life insurers, would still be required to establish, test, verify, maintain, and enforce procedures for the activities in which they did not engage.¹³ The commenter stated that it was concerned about this requirement because NASD has, in the past, required all broker/dealers to have procedures in place for all activities requiring USA PATRIOT Act compliance under Rule 3011 regardless whether all of the broker/dealers engaged in those activities.

RESPONSE: Compliance with the USA PATRIOT Act is required under federal statute, and NASD cannot alter or exempt any member from this requirement. NASD, however, does not expect a member to have in place the inspection and supervisory procedures described in Rules 3010 and 3012 for activities in which it does not engage, provided that the member identifies the activities not engaged in and documents the fact that it cannot engage in such activities without having in place the procedures required by these rules.

Accordingly, Rule 3010(c)(2) beginning on pages five and thirty-two should be revised to read as follows (new language is underlined and deleted text is [bracketed]):

(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:

¹³ American Council of Life Insurers, Carl B. Wilkerson, Chief Counsel, Securities & Litigation (October 3, 2003).

- (A) Safeguarding of customer funds and securities;
- (B) Maintaining books and records;
- (C) Supervision of customer accounts serviced by branch office managers;
- (D) Transmittal of funds between customers and registered representatives and between customers and third parties;
- (E) Validation of customer address changes; and
- (F) Validation of changes in customer account information.

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

Also, Rule 3012(a)(2)(B) beginning on pages eight and thirty-five should be revised to read as follows (new language is underlined and deleted text is [bracketed]):

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

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

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

Rule 3010 (Supervision)

The amendments eliminate the requirement proposed in the original rule filing that office inspections mandated in NASD Rule 3010(c) be conducted by independent persons. Instead, the amendments only restrict the branch office manager or any person within that office who has supervisory responsibilities or any individual who is supervised by such person(s) from conducting office inspections. The amendments require each member to inspect: (1) offices of supervisory jurisdiction and supervisory branch offices at least annually; (2) non-supervisory branch offices at least every three years; and (3) non-branch locations on a regular periodic schedule. Office inspections must be reduced to a written report and kept on file for a minimum of three years. In addition, the amendments to the original rule filing require heightened inspection procedures for certain situations that involve a producing manager who is responsible for generating 20% or more of the income of the producing manager's supervisor.

A. Are Rule 3010 inspection reports subject to direct review by NASD examiners or can they be made available upon request?

COMMENTS: One commenter asked whether the written reports of office inspections required by Rule 3010(c)(2) to be kept on file are subject to direct review by NASD examiners during the course of an examination or whether they can be made available upon request.¹⁴

RESPONSE: NASD expects a member to produce the office inspection reports during an examination by any government entity or self-regulatory organization if the information contained in the reports is relevant to the subject matter of the examination or if it is requested for production by the government entity or self-regulatory organization.

B. NASD should eliminate or provide more specific detail on the requirement to inspect non-branch locations.

COMMENTS: More than one commenter stated that NASD should either eliminate or provide greater detail on the requirement in Rule 3010(c) to inspect non-branch locations on a regular periodic schedule.¹⁵

RESPONSE: As NASD stated in the response to comments to the original rule filing, the provision requiring members to inspect non-branch locations on a regular periodic schedule codifies previous and consistent NASD guidance on this issue.¹⁶ NASD

¹⁴ Associated Securities Corp., Neal E. Nakagiri, President and CEO (October 2, 2003).

¹⁵ Pacific Select Distributors, S. Kendrick Dunn, Assist. VP (October 3, 2003); United Planners' Financial Services of America, Julie Gebert, VP, Director of Compliance (October 3, 2003).

¹⁶ See NASD *Notice to Members* 98-38 (May 1998); NASD *Notice to Members* 99-45 (June 1999).

members should already be familiar with the requirement to inspect non-branch locations and should currently be conducting such inspections.

C. The minimum three-year period for office inspections is contrary to previous NASD guidance regarding how often offices should be inspected, is contrary to industry practice, and presents broker/dealers with the opportunity to reduce office inspection frequency.

COMMENTS: One commenter suggested that NASD's codification of a minimum three-year inspection period for "certain non-registered and/or non-supervisory branch offices" was inappropriate and could have a detrimental effect on the overall supervisory systems for firms with remote office locations. The commenter stated that this codification is contrary to previous NASD guidance regarding how often offices should be inspected. In addition, the commenter stated that the minimum three-year inspection period is contrary to industry practice and presents broker/dealers with the opportunity to reduce office inspection frequency.¹⁷

RESPONSE: NASD believes that these comments do not reflect a clear understanding of the amendments to Rule 3010 to codify minimum inspection periods for non-supervisory branch offices and unregistered office locations. Nor do they accurately reflect NASD's previous guidance on the frequency of inspection cycles for these offices. Prior to the amendments, Rule 3010 required only that branch offices be inspected "according to a cycle which shall be set forth in the firm's written supervisory and inspection procedures."¹⁸ Without specifying the frequency of these cycles, subsequent NASD guidance clarified that non-supervisory branch offices had to be "reviewed in accordance with a stated cycle," while branch offices that supervised one or more locations had to be inspected annually.¹⁹

The amendments to Rule 3010 now specify that the members must establish a minimum three-year inspection cycle for non-supervisory branch offices. In addition, members must consider whether the nature and complexity of a branch office's securities activities, the branch office's volume of business, and the number of associated persons assigned to the branch office require inspections more frequently than every three years. Members must set forth in their written supervisory and inspection procedures the examination cycle and an explanation of the factors the member used in determining the frequency of the cycle. NASD views these changes as significantly increasing oversight and supervision of non-supervisory branch offices and does not agree with the

¹⁷ Monahan & Roth LLC, Lisa Roth, President (October 30, 2003).

¹⁸ NASD Rule 3010(c)(1).

¹⁹ *Id.*

commenter's view that the minimum three-year inspection period presents broker/dealers with the opportunity to reduce office inspection frequency.

Additionally, amended Rule 3010's requirement that every non-branch location be inspected on a regular periodic cycle codifies previous NASD guidance requiring unregistered offices to be inspected according to a regular schedule. Members must also consider the nature and complexity of the location's securities activities and the nature and extent of contact with customers in establishing the inspection cycle and set forth in their written supervisory and inspection procedures an explanation regarding how they determined the frequency of the examination schedule. NASD views these changes as significantly increasing supervision and oversight of unregistered offices.

- D. Please clarify that a member that conducts examinations of non-supervisory branch offices more frequently than the minimum three-year period prescribed in Rule 3010 will not violate Rule 3010, even if such examinations do not inspect all of the areas required by Rule 3010.**

COMMENTS: At least one commenter stated that members often conduct examinations of non-supervisory branch offices more than once every three years to ensure that supervisors maintain regular and frequent professional contact but that these examinations did not always cover every area required under the amendments to Rule 3010.²⁰ The commenter requested assurance that these more frequent inspections would not violate Rule 3010, even if they were not designed to comply strictly with Rule 3010's requirements.

RESPONSE: NASD understands that members may have in place inspection cycles that require more frequent non-supervisory branch office inspections than at least once every three years but that target only certain areas of the offices' activities during a particular examination. Recognizing this existing practice, NASD is amending Rule 3010(c)(2) to take into account that a member may inspect non-supervisory branch offices more frequently than every three years. However, Rule 3010 mandates that the inspection and subsequent written report of non-supervisory branch offices include the testing and verification of the member's policies and procedures, including supervisory policies and procedures in safeguarding of customer funds and securities, maintaining books and records, supervision of producing managers' customer accounts, transmittals of customer funds, and validation of changes in customers' addresses and account information. Accordingly, amended Rule 3010 will require a member to inspect these areas within the three-year cycle specified in the rule, regardless of the number of times within that cycle a non-supervisory branch office is inspected.

²⁰ Mass Mutual Financial Group, Robert S. Rosenthal, Second VP & Assoc. General Counsel (August 29, 2003).

Rule 3010(c)(1)(B) beginning on pages four and thirty-one should be revised to read as follows (new language is underlined and deleted text is [bracketed]):

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

E. To assure integrity in the inspection process, NASD should clarify that persons responsible for office inspections cannot report directly or indirectly to the branch office's sales manager and require inspection reports to be sent directly to the compliance department.

COMMENTS: One commenter stated that NASD should assure the integrity of office inspections by restricting persons responsible for office inspections from reporting directly or indirectly to the branch office's sales manager. Additionally, NASD should require members to send inspection reports directly to the compliance department.²¹

RESPONSE: The amendments to Rule 3010 restrict the branch office manager or any person within that office who has supervisory responsibilities or any individual who is supervised by such person(s) from conducting office inspections. NASD does not believe that additional restrictions on the persons appropriate to conduct office inspections would necessarily increase the integrity of office inspections. NASD also does not believe that mandating how a member routes inspection reports would increase the office inspection's integrity or increase a member's responsibility to ensure that its offices are complying with the applicable securities laws and regulations and NASD rules. Members are responsible for ensuring that any areas of insufficiency revealed by an inspection report are corrected regardless of how those reports are routed within a firm. Additionally, amended Rule 3010 already requires members to reduce office inspections to a written report and keep them on file for a minimum of three years.

²¹ North American Securities Administrators Association, Inc., Ralph A. Lambiase, President and Director, Connecticut Division of Securities (October 24, 2003).

F. NASD should require chief executive officers (“CEOs”) and chief compliance officers (“CCOs”) to certify that broker-dealers have adequate compliance and supervisory policies and procedures.

COMMENTS: One commenter suggested that NASD should amend the supervisory control amendments to require CEOs and CCOs to certify that firms have adequate compliance and supervisory policies and procedures.²²

RESPONSE: NASD believes that the proposed amendments put in place appropriate measures to ensure a member’s responsibility for its supervisory control policies and procedures. New Rule 3012 already requires each member to designate and identify one or more principals who will establish, maintain, and enforce a system of supervisory control policies and procedures that test and verify that the supervisory procedures are reasonably designed to achieve compliance with applicable securities laws and regulations and with applicable NASD rules. Those principals are also required to amend the member’s supervisory procedures or create additional procedures where testing and verification indicates a need. In addition, the principals must submit to the member’s senior management an annual report detailing the supervisory control system, the summary of the test results, and any additions or amendments created in response to the test results. Finally, NASD recently filed with the SEC a rule proposal to require each member to designate a CCO and further require the member’s CEO and CCO to certify annually that the member has in place a process to establish, maintain, review, modify, and test policies and procedures reasonably designed to achieve compliance with applicable NASD rules, Municipal Securities Rulemaking Board rules, and the federal securities laws.²³

G. More clarification is needed regarding who can conduct an office inspection.

RESPONSE: Rule 3010(c)(3) states that a branch office manager or any person within that office who has supervisory responsibility or any individual who is supervised by such person(s) cannot conduct an office inspection. Several commenters requested clarification regarding this provision.²⁴ Specifically, the commenters asked who could conduct an office inspection if a firm has small or single-person satellite offices that report to an office of supervisory jurisdiction (“OSJ”), rather than to a separate branch office. The commenters asked whether the OSJ manager, who may also be considered the branch office manager of the small offices under some business models, could conduct the office inspection.

²² Id.

²³ SR-NASD-2003-176 (November 11, 2003).

²⁴ Mass Mutual Financial Group, Robert S. Rosenthal, Second VP & Assoc. General Counsel (August 29, 2003); Sonnenschein, Nath & Rosenthal, LLP, Terry L. Lister, Of Counsel (September 30, 2003).

NASD understands that members have different business models and that some members may be so limited in both size and resources that their business models do not make it possible to comply fully with the restrictions regarding who can conduct an office inspection. Examples of such situations would include a member that has only one office or has a business model where small or single-person offices report directly to an OSJ manager who is also considered the offices' branch office manager. In such situations, a member of limited size and resources may continue to use the persons they have previously used to conduct the office inspections required under Rule 3010 provided that they are principals and have the requisite knowledge to conduct such inspections. Members, however, must be able to document that their size and resources are such that they have no other alternative.

Therefore, Rule 3010(c)(3) beginning on pages five and thirty-three should be revised to read as follows (new language is underlined and deleted text is [bracketed]):

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

Rule 2510 (Discretionary Accounts)

Proposed amendments 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. However, the one-day limit on time and price discretionary authority would not apply to time and price discretion exercised for orders effected with or for an institutional account pursuant to valid Good-Till-Cancelled instructions issued on a "not held" basis.

COMMENTS: One commenter stated that Rule 2510(d) should contain a requirement that firms notify their clients of the one-day limit on time and price discretionary authority. The commenter believed that informing customers would better protect them.²⁵

²⁵ Pace University School of Law, Barbara Black, Director, Jill I. Gross, Director, Jessica Longobardi, Student Intern (October 2, 2003).

RESPONSE: NASD believes that the commenter may misperceive the purpose of the amendment to Rule 2510(d)(1). The intent of the amendment is to provide greater investor protection by clarifying the terms of an order given pursuant to price and time discretion pertaining to the time such an order remains pending. NASD believes that the amendment achieves its stated purpose.

IM-3110(i) (Holding of Customer Mail)

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

COMMENTS: One commenter stated that NASD should provide a limited exception that would allow a firm, when necessary, to receive and hold a customer's mail for a longer time than the two-month and three-month limits proposed in IM-3110(i).²⁶

RESPONSE: NASD continues to believe that the time periods mentioned in the rules are appropriate. As NASD stated in the response to comment to the original rule filing, the amendments to IM-3110(i) will help to ensure that members that do hold mail for customers who are away from their usual addresses, do so only pursuant to the customers' written instructions and for a specified, relatively short period of time, thereby reducing the likelihood of risk that customers do not receive account statements or other account documentation at their usual addresses. In addition, the rule will help to ensure that customers provide the firms with which they do business current address information, insofar as a firm will not be permitted to hold mail indefinitely.

If you have any questions regarding this response to comments, please do not hesitate to call me at (202) 728-8026.

Very truly yours,

Patricia Albrecht

²⁶ Associated Securities Corp., Neal E. Nakagiri, President and CEO (October 2, 2003).