

July 30, 2004

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-2004-116 - Amendments to Supervisory Control and
Inspection Procedures Rules**

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 M. Albrecht, Office of General Counsel, Regulatory Policy and Oversight, 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-2004-116
Consists of 33 Pages
July 30, 2004

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”) a proposed rule change to align certain supervisory control and inspection requirements in NASD Rules 3010 and 3012 with the supervisory control and inspection requirements in New York Stock Exchange (“NYSE”) Rules 342.19 and 342(a)(b)/03. The SEC approved these rules on June 17, 2004.¹ In addition, NASD is proposing several non-substantive technical amendments. Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

* * * * *

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] in 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) through (b) No change.

(c) Internal Inspections

(1) through (2) No change.

(3) An office inspection by a member pursuant to paragraph (c)(1) may not be conducted by the branch office manager or any person within that office who has supervisory responsibilities or by any individual who is directly or indirectly supervised by such person(s). However, if a member is so limited in size and resources that it cannot comply with this limitation (e.g., a member [with] has 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

¹ See SR-NASD-2002-162 (November 4, 2002); Exchange Act Rel. No. 49883 (June 17, 2004), 69 F.R. 35092 (June 23, 2004) (order approving NASD’s proposed rule change); Exchange Act Rel. No. 49882 (June 17, 2004); 69 F.R. 35108 (June 23, 2004) (order approving NYSE’s proposed rule change).

inspection reports the factors it has relied upon in determining that it is so limited in size and resources that it has no other alternative than to comply in this manner.

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

(d) through (g) No Change.

* * * * *

3012. Supervisory Control System

(a) General Requirements

(1) No change.

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

(A) procedures that are reasonably designed to review and supervise the customer account activity conducted by the member's branch office managers, sales managers, regional or district sales managers, or any person performing a similar supervisory function.

(i) A person who is either senior to ,or otherwise independent of, the producing manager must perform such supervisory reviews. For purposes of this Rule, an "otherwise independent" person: may not report either directly or indirectly to the producing manager under review; must be situated in an office other than the office of the producing manager; must not otherwise have supervisory responsibility over the activity being reviewed (including not being directly compensated based in whole or in part on the revenues accruing for those activities); and must alternate such review responsibility with another qualified person every two years or less. [However, if a member (i) does not conduct a public business, (ii) or has a capital requirement of \$5,000 or less, or (iii) employs 10 or fewer representatives and, in

the case of (i) through (iii), its business is conducted in a manner necessitated by a limitation of resources that includes fewer than two layers of supervisory personnel, a person in another office of the member who is in the same or similar position to the producing manager may conduct the supervisory reviews, provided that the person in the same or similar position does not have supervisory responsibility over the activity being reviewed, reports to his supervisor his supervision and review of the producing manager, and has not performed a review of the producing manager in the last two years.]

(ii) If a member is so limited in size and resources that there is no qualified person senior to, or otherwise independent of, the producing manager to conduct the reviews pursuant to (i) above [it cannot avail itself of this exception] (e.g., a member [with] has only one office or [a member with two offices and] an insufficient number of qualified personnel who can conduct reviews on a [two] one-year rotation), [a member may have] the reviews may be conducted by a principal who is sufficiently knowledgeable of the member's supervisory control procedures[conduct these reviews], provided that the reviews are in compliance with (i) to the extent practicable.

(iii) A member relying on (ii) above must document in its supervisory control procedures the factors used to determine that

complete compliance with all of the provisions of (i) is not possible and that the required supervisory systems and procedures in place with respect to any producing manager comply with the provisions of (i) above to the extent practicable. [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) 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] to third party accounts (i.e., a transmittal that would result in a change of beneficial ownership); from customer accounts to outside entities (e.g., banks, investment companies, etc.); from customer accounts to locations other than a customer's primary residence (e.g., post office box, "in care of" accounts, alternate address, etc.); and between customers and registered representatives, including the hand-delivery of checks;

(ii) through (iii) No change.

The policies and procedures established pursuant to paragraph (a)(2)(B) must include a means or method of customer confirmation, notification, or follow-up that can be documented. If a member does not engage in all of the activities enumerated above, the member must identify

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

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

(b) No change.

* * * * *

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

(a) The 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 amendments to NASD Rules without recourse to the membership for approval.

The proposed rule change amends the recently approved changes to Rules 3010 and 3012, which become effective on December 17, 2004.² The proposed rule change will also become effective on December 17, 2004.

NASD previously stated in Amendment No. 1 to SR-NASD-2002-162 (the approved supervisory control and inspection procedures rule change) that it would publish a Notice to Members announcing the effective date of the rules no later than 60 days following Commission approval. In light of these proposed rule changes, which have the same effective date of December 17, 2004, NASD is delaying publishing a Notice to Members regarding the new supervisory control and inspection procedures

² See SR-NASD-2002-162 (November 4, 2002); Exchange Act Rel. No. 49883 (June 17, 2004), 69 F.R. 35092 (June 23, 2004) (order approving NASD's proposed rule change).

rules until it can also announce in the Notice to Members the approval and effective date of the amendments resulting from this proposed rule change. Accordingly, NASD will publish a Notice to Members announcing the effective date of these rules no later than 30 days following Commission approval of this rule filing. NASD believes that publishing the final version of the approved rules on supervisory control and inspection procedures will reduce the likelihood of member confusion as to the requirements of the rules.

As further detailed in Section 7 below, NASD is requesting that the SEC grant accelerated approval to the proposed rule change.

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

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

(a) Purpose

On June 17, 2004, the SEC approved proposed changes to NASD and NYSE rules generally requiring the establishment, maintenance, and testing of supervisory control procedures, enhanced inspection procedures, documentation and recordkeeping procedures for account name/designation changes, limitations on holding customer mail, and a one-day limit on time and price discretionary authority for retail customer orders.³ NASD's and NYSE's new requirements are substantially similar; however, given the particular nature and substance of these rules as well as the SEC's, NASD's, and the NYSE's original goal of aligning the substance of these specific rules, NASD believes

that this similarity should be enhanced by conforming certain inspection and supervisory control requirements in Rules 3010 and 3012 to the corresponding inspection and supervisory control requirements in NYSE Rule 342.19 and 342(a)(b)/03.

Rule 3010(c) (“Internal Inspections”)

Rule 3010(c)(3) prohibits a branch office manager or any person within that office who has supervisory responsibilities or any individual who is supervised by such person from conducting an office inspection. NYSE Rule 342(a)(b) /03 (“Annual Branch Office Inspection”), however, specifies that any person who *directly or indirectly* reports to the branch office manager is prohibited from conducting an office inspection. NASD proposes to revise Rule 3010(c)(3) to similarly specify that any individual who is *directly or indirectly* supervised by the branch office manager is prohibited from conducting an office inspection.

Rule 3012 (Supervisory Control System)

Rule 3012(a)(2)(A) requires members’ supervisory control policies and procedures to include procedures that are reasonably designed to review and supervise the customer account activity conducted by the member’s branch office managers, sales managers, regional or district sales managers, or any person performing a similar supervisory function and generally requires that only a person who is senior to the producing manager may perform such supervisory reviews. Rule 3012(a)(2)(A) also provides a limited exception from the seniority requirement if a member (i) does not conduct a public business, (ii) or has a capital requirement of \$5,000 or less, or (iii)

³ See *id.*; Exchange Act Rel. No. 49882 (June 17, 2004); 69 F.R. 35108 (June 23, 2004) (order approving NYSE’s proposed rule change).

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 member meeting these conditions may have a person in another office who is in the same or similar position to the producing manager 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.

NYSE Rule 342.19 (“Supervision of Producing Managers”) does not provide a size-based exception, and instead, generally requires all members to have a person who is either senior to or “otherwise independent” of the producing manager perform the supervisory reviews. According to NYSE Rule 342.19, “an ‘otherwise independent’ person: may not report either directly or indirectly to the Producing Manager under review; must be situated in an office other than the office of the Producing Manager; must not otherwise have supervisory review over the activity being reviewed; and must alternate such review responsibility with another qualified person every two years or less.”

NASD is proposing to eliminate the size-based exception described above and modify its general standard for supervisory reviews to reflect the NYSE’s “senior to or otherwise independent of” approach. NASD believes that adopting this approach will enable more members to use the general standard for its supervisory reviews instead of needing to rely on the size-based exception. The proposed rule change will also provide members with the same flexibility in structuring their supervisory review policies and

procedures that the NYSE members have.

Accordingly, for purposes of Rule 3012, an “otherwise independent” person may not report either directly or indirectly to the producing manager under review, must be situated in an office other than the office of the producing manager, must not otherwise have supervisory responsibility over the activity being reviewed, and must alternate such review responsibility with another qualified person every two years or less. The requirement that such “otherwise independent” person not otherwise have supervisory responsibility over the activity being reviewed includes that such person is not directly compensated based in whole or in part on the revenues accruing from those activities.

NASD considers an “otherwise independent” person who conducts supervisory reviews to be a supervisor for purposes of compliance with the supervisory review provisions of Rule 3012, even though, by definition, the “otherwise independent” person may not otherwise supervise the activity being reviewed. However, NASD does not consider an “otherwise independent” person to be a supervisor for purposes of determining whether a producing manager is responsible for generating 20% or more of the revenue of the business units supervised by the producing manager’s supervisor, such that heightened supervisory procedures must be put in place. The factors that define an “otherwise independent” person already protect against the possibility that any conflicts of interest may exist that might adversely affect the supervisory review. In particular, as discussed above, an “otherwise independent” person may not be directly compensated based in whole or in part on the revenues accruing from the activities being reviewed.

Both Rule 3012 and NYSE Rule 342.19 provide a member that is so limited in size and resources that it cannot meet the general supervisory review standard with an

exception that allows the member to have a principal who is sufficiently knowledgeable conduct the supervisory reviews. However, NASD and NYSE have different documentation standards that a member must comply with when relying on this exception. Rule 3012 requires that the member document the factors it has relied upon in determining that its size and resources available to it are so limited that the member has no other alternative than to comply in this manner. NYSE Rule 342.19, meanwhile, provides a similar exception, but provides that the member relying on the exception must document the factors used to determine that complete compliance with all of the provisions of the “senior to or otherwise independent of” standard is not possible and that the required supervisory systems and procedures comply with the provisions of that standard, to the extent possible.

NASD is proposing to revise Rule 3012 to substitute the current documentation requirements with requirements similar to those in NYSE Rule 342.19. NASD believes that the documentation required by NYSE Rule 342.19 will result in members providing greater detail regarding the factors relied upon in determining that they must use the exception rather than the general supervisory review standard, as well as how closely their policies and practices track the general requirements.⁴

Non-Substantive Editorial Changes

Finally, NASD has made several non-substantive changes to Rules 2510 (“Discretionary Accounts”) and Rule 3012 to enhance the readability of the statutory

⁴ NYSE Rule 342.19 provides an example of a firm so limited in size and resources as a firm with an insufficient number of qualified personnel who can conduct reviews on a two-year rotation. NASD believes that, for its members’ edification, a more illustrative example would be a member with an

language.

(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 is imposing these requirements on NASD members to ensure that they have in place standards that are reasonably designed to prevent fraudulent and manipulative acts, thereby protecting investors and the public interest. In addition, in light of the nature and content of these particular rules, NASD believes that NASD's and the NYSE's rules in this area should be substantially similar.

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

Written comments were neither solicited nor received.

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)

insufficient number of qualified personnel who can conduct reviews on a one-year rotation. Accordingly, NASD is proposing to amend the rule text to reflect that view.

NASD requests the Commission to find good cause pursuant to Section 19(b)(2) for approving the proposed rule change prior to the 30th day after its publication in the Federal Register. The proposed rule change is amending recently approved rule changes that have an effective date of December 17, 2004. Both the recently approved rule change and this proposed rule change impose significant inspection and supervisory control obligations that will likely require members to make changes to their current supervisory and inspection policies and procedures. Granting accelerated approval will enable NASD to announce promptly the final approved rules, as modified to reflect the amendments contained in this rule change, thus lessening member confusion as to the final requirements of Rules 3010 and 3012, and permitting members to make the necessary changes to comply with the requirements of these rules.

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

NASD is filing this proposed rule change to align certain supervisory control and inspection requirements in NASD Rules 3010 and 3012 with the supervisory control and inspection requirements in New York Stock Exchange (“NYSE”) Rules 342.19 and 342(a)(b)/03.

9. Exhibits

1. Completed notice of proposed rule change for publication in the Federal Register.

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: July 30, 2004

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-NASD-2004-116)

Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Amendments to the Supervisory Control and Inspection Procedures Rules

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”) 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. For the reasons discussed below, the Commission is granting accelerated approval of the proposed rule change.]

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE

NASD is proposing to amend Rules 3010 and 3012, to align certain supervisory control and inspection requirements with the corresponding supervisory control and inspection requirements in New York Stock Exchange (“NYSE”) Rules 342.19 and 342(a)(b)/03. The SEC approved these rules on June 17, 2004.³ In addition, NASD is

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See SR-NASD-2002-162 (November 4, 2002); Exchange Act Rel. No. 49883 (June 17, 2004), 69 F.R. 35092 (June 23, 2004) (order approving NASD’s proposed rule change); Exchange Act Rel. No. 49882 (June 17, 2004); 69 F.R. 35108 (June 23, 2004) (order approving NYSE’s proposed rule change).

proposing several non-substantive technical amendments. Below is the 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.

(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] in 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) through (b) No change.

(c) Internal Inspections

(1) through (2) No change.

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

A member must have in place procedures that are reasonably designed to provide heightened office inspections if the person conducting the inspection reports to the branch office manager's supervisor or works in an office supervised by the branch manager's supervisor and the branch office manager generates 20% or more of the revenue of the business units supervised by the branch office manager's supervisor. For the purposes of this subsection only, the term "heightened inspection" shall mean those inspection procedures that are designed to avoid conflicts of interest that

serve to undermine complete and effective inspection because of the economic, commercial, or financial interests that the branch manager's supervisor holds in the associated persons and businesses being inspected. In addition, for the purpose of this section only, when calculating the 20% threshold, all of the revenue generated by or credited to the branch office or the branch office manager shall be attributed as revenue generated by the business units supervised by the branch office manager's supervisor irrespective of a member's internal allocation of such revenue. A member must calculate the 20% threshold on a rolling, twelve-month basis.

(d) through (g) No Change.

* * * * *

3012. Supervisory Control System

(a) General Requirements

(1) No change.

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

(A) procedures that are reasonably designed to review and supervise the customer account activity conducted by the member's branch office managers, sales managers, regional or district sales managers, or any person performing a similar supervisory function.

(i) A person who is either senior to or otherwise independent of, the producing manager must perform such

supervisory reviews. For purposes of this Rule, an “otherwise independent” person: may not report either directly or indirectly to the producing manager under review; must be situated in an office other than the office of the producing manager; must not otherwise have supervisory responsibility over the activity being reviewed (including not being directly compensated based in whole or in part on the revenues accruing for those activities); and must alternate such review responsibility with another qualified person every two years or less. [However, if a member (i) does not conduct a public business, (ii) or has a capital requirement of \$5,000 or less, or (iii) employs 10 or fewer representatives and, in the case of (i) through (iii), its business is conducted in a manner necessitated by a limitation of resources that includes fewer than two layers of supervisory personnel, a person in another office of the member who is in the same or similar position to the producing manager may conduct the supervisory reviews, provided that the person in the same or similar position does not have supervisory responsibility over the activity being reviewed, reports to his supervisor his supervision and review of the producing manager, and has not performed a review of the producing manager in the last two years.]

(ii) If a member is so limited in size and resources that there is no qualified person senior to, or otherwise independent of,

the producing manager to conduct the reviews pursuant to (i) above [it cannot avail itself of this exception] (e.g., a member [with] has only one office or [a member with two offices and] an insufficient number of qualified personnel who can conduct reviews on a [two] one-year rotation), [a member may have] the reviews may be conducted by a principal who is sufficiently knowledgeable of the member's supervisory control procedures[conduct these reviews], provided that the reviews are in compliance with (i) to the extent practicable.

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

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

(ii) through (iii) No change.

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

(C) procedures that are reasonably designed to provide heightened supervision over the activities of each producing manager who is responsible for generating 20% or more of the revenue of the business units supervised by the producing manager's supervisor. For the purposes of this subsection only, the term "heightened supervision" shall mean those supervisory procedures that evidence supervisory activities that are designed to avoid conflicts of interest that serve to undermine complete and effective supervision because of the economic, commercial, or

financial interests that the supervisor holds in the associated persons and businesses being supervised. In addition, for the purpose of this section only, when calculating the 20% threshold, all of the revenue generated by or credited to the producing manager or the producing manager's office shall be attributed as revenue generated by the business units supervised by the producing manager's supervisor irrespective of a member's internal allocation of such revenue. A member must calculate the 20% threshold on a rolling, twelve-month basis.

(b) 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

1. Purpose

On June 17, 2004, the SEC approved proposed changes to NASD and NYSE rules generally requiring the establishment, maintenance, and testing of supervisory control procedures, enhanced inspection procedures, documentation and recordkeeping procedures for account name/designation changes, limitations on holding customer mail,

and a one-day limit on time and price discretionary authority for retail customer orders.⁴ NASD's and NYSE's new requirements are substantially similar; however, given the particular nature and substance of these rules as well as the SEC's, NASD's, and the NYSE's original goal of aligning the substance of these specific rules, NASD believes that this similarity should be enhanced by conforming certain inspection and supervisory control requirements in Rules 3010 and 3012 to the corresponding inspection and supervisory control requirements in NYSE Rule 342.19 and 342(a)(b)/03.

Rule 3010(c) ("Internal Inspections")

Rule 3010(c)(3) prohibits a branch office manager or any person within that office who has supervisory responsibilities or any individual who is supervised by such person from conducting an office inspection. NYSE Rule 342(a)(b) /03 ("Annual Branch Office Inspection"), however, specifies that any person who *directly or indirectly* reports to the branch office manager is prohibited from conducting an office inspection. NASD proposes to revise Rule 3010(c)(3) to similarly specify that any individual who is *directly or indirectly* supervised by the branch office manager is prohibited from conducting an office inspection.

Rule 3012 (Supervisory Control System)

Rule 3012(a)(2)(A) requires members' supervisory control policies and procedures to include procedures that are reasonably designed to review and supervise the customer account activity conducted by the member's branch office managers, sales managers, regional or district sales managers, or any person performing a similar

⁴ See *id.*; Exchange Act Rel. No. 49882 (June 17, 2004); 69 F.R. 35108 (June 23, 2004) (order approving NYSE's proposed rule change).

supervisory function and generally requires that only a person who is senior to the producing manager may perform such supervisory reviews. Rule 3012(a)(2)(A) also provides a limited exception from the seniority requirement if a member (i) does not conduct a public business, (ii) or has a capital requirement of \$5,000 or less, or (iii) employs 10 or fewer representatives and, in the case of (i) through (iii), its business is conducted in a manner necessitated by a limitation of resources that includes fewer than two layers of supervisory personnel. A member meeting these conditions may have a person in another office who is in the same or similar position to the producing manager 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.

NYSE Rule 342.19 (“Supervision of Producing Managers”) does not provide a size-based exception, and instead, generally requires all members to have a person who is either senior to or “otherwise independent” of the producing manager perform the supervisory reviews. According to NYSE Rule 342.19, “an ‘otherwise independent’ person: may not report either directly or indirectly to the Producing Manager under review; must be situated in an office other than the office of the Producing Manager; must not otherwise have supervisory review over the activity being reviewed; and must alternate such review responsibility with another qualified person every two years or less.”

NASD is proposing to eliminate the size-based exception described above and modify its general standard for supervisory reviews to reflect the NYSE’s “senior to or

otherwise independent of” approach. NASD believes that adopting this approach will enable more members to use the general standard for its supervisory reviews instead of needing to rely on the size-based exception. The proposed rule change will also provide members with the same flexibility in structuring their supervisory review policies and procedures that the NYSE members have.

Accordingly, for purposes of Rule 3012, an “otherwise independent” person may not report either directly or indirectly to the producing manager under review, must be situated in an office other than the office of the producing manager, must not otherwise have supervisory responsibility over the activity being reviewed, and must alternate such review responsibility with another qualified person every two years or less. The requirement that such “otherwise independent” person not otherwise have supervisory responsibility over the activity being reviewed includes that such person is not directly compensated based in whole or in part on the revenues accruing from those activities.

NASD considers an “otherwise independent” person who conducts supervisory reviews to be a supervisor for purposes of compliance with the supervisory review provisions of Rule 3012, even though, by definition, the “otherwise independent” person may not otherwise supervise the activity being reviewed. However, NASD does not consider an “otherwise independent” person to be a supervisor for purposes of determining whether a producing manager is responsible for generating 20% or more of the revenue of the business units supervised by the producing manager’s supervisor, such that heightened supervisory procedures must be put in place. The factors that define an “otherwise independent” person already protect against the possibility that any conflicts of interest may exist that might adversely affect the supervisory review. In particular, as

discussed above, an “otherwise independent” person may not be directly compensated based in whole or in part on the revenues accruing from the activities being reviewed.

Both Rule 3012 and NYSE Rule 342.19 provide a member that is so limited in size and resources that it cannot meet the general supervisory review standard with an exception that allows the member to have a principal who is sufficiently knowledgeable conduct the supervisory reviews. However, NASD and NYSE have different documentation standards that a member must comply with when relying on this exception. Rule 3012 requires that the member document the factors it has relied upon in determining that its size and resources available to it are so limited that the member has no other alternative than to comply in this manner. NYSE Rule 342.19, meanwhile, provides a similar exception, but provides that the member relying on the exception must document the factors used to determine that complete compliance with all of the provisions of the “senior to or otherwise independent of” standard is not possible and that the required supervisory systems and procedures comply with the provisions of that standard, to the extent possible.

NASD is proposing to revise Rule 3012 to substitute the current documentation requirements with requirements similar to those in NYSE Rule 342.19. NASD believes that the documentation required by NYSE Rule 342.19 will result in members providing greater detail regarding the factors relied upon in determining that they must use the exception rather than the general supervisory review standard, as well as how closely their policies and practices track the general requirements.⁵

Non-Substantive Editorial Changes

Finally, NASD has made several non-substantive changes to Rules 2510 (“Discretionary Accounts”) and Rule 3012 to enhance the readability of the statutory language.

2. 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 is imposing these requirements on NASD members to ensure that they have in place standards that are reasonably designed to prevent fraudulent and manipulative acts, thereby protecting investors and the public interest. In addition, in light of the nature and content of these particular rules, NASD believes that NASD's and the NYSE's rules in this area should be substantially similar.

(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

Written comments were neither solicited nor received.

⁵ NYSE Rule 342.19 provides an example of a firm so limited in size and resources as a firm with an insufficient number of qualified personnel who can conduct reviews on a two-year rotation. NASD believes that, for its members' edification, a more illustrative example would be a member with an

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

NASD has requested that the Commission find good cause pursuant to Section 19(b)(2) for approving the proposed rule change prior to the 30th day after publication in the Federal Register. The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to NASD and, in particular, the requirements of Section 15A and the rules and regulations thereunder. The proposed rule change is amending recently approved rule changes that have an effective date of December 17, 2004. Both the recently approved rule change and this proposed rule change impose significant inspection and supervisory control obligations that will likely require members to make changes to their current supervisory and inspection policies and procedures. Accordingly, the Commission finds good cause for approving the proposed rule change prior to the 30th day after the date of publication of notice of filing thereof in that accelerated approval will enable NASD to announce promptly the final approved rules, as modified to reflect the amendments contained in this approved rule change, thus lessening member confusion as to the final requirements of Rules 3010 and 3012, and permitting members to make the necessary changes to comply with the requirements of these rules. The effective date of the approved rule change will be December 17, 2004.

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

insufficient number of qualified personnel who can conduct reviews on a one-year rotation. Accordingly, NASD is proposing to amend the rule text to reflect that view.

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. Comments may also be submitted electronically at the following e-mail address: rule-comments@sec.gov. All comment letters should refer to File No. SR-NASD-2004-116. This file number should be included on the subject line if e-mail is used. To help us process and review comments more efficiently, comments should be sent in hardcopy or by e-mail but not by both methods. 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].

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that the

proposed rule change be, and hereby is, approved.

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