



October 3, 2003

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: File Nos. SR-NYSE-2002-36 and SR-NASD-2002-162

Dear Mr. Katz:

The Self-Regulation and Supervisory Practices Committee (the “Committee”) of the Securities Industry Association (“SIA”)¹ appreciates the opportunity to comment on amendments to proposed rule changes submitted by the New York Stock Exchange, Inc. (“NYSE”)² and National Association of Securities Dealers, Inc. (“NASD”)³ designed to enhance members’ supervisory control procedures. As detailed in our comments to the initial proposals,⁴ the Committee generally endorses the stated objectives of the NASD and NYSE’s (collectively the “SROs”) proposals, which we view as consistent with good business practices and existing controls within many member firms.

Subject to the additional concerns and comments detailed below, we generally support the amendments as constructive improvements to the rules proposed last year. We believe, however, that certain provisions require additional clarification and slight modification, and if left unresolved would cause unnecessary confusion and subject firms to undue hardship, as well as potentially inconsistent regulation. These provisions

¹ The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2002, the industry generated \$222 billion in domestic revenue and \$356 billion in global revenues. (More information about SIA is available on its home page: www.sia.com)

² Securities Exchange Act Release No. 46858 (November 20, 2002), 67 FR 70994.

³ Securities Exchange Act Release No. 46859 (November 20, 2002), 67 FR 70990.

⁴ SIA Letter to Jonathan G. Katz, dated December 18, 2002, located at www.sia.com/2002_comment_letters/.

include, among others, those governing independent supervision of managers' activity, branch office examinations, designation of registered principals to test and verify member firm supervisory systems, and time and price discretion. We therefore urge the Commission and SROs to consider our comments and alternatives offered below.

I. Review and Supervision of Managers' Activity

Both SRO proposals contain provisions governing independent review and supervision of sales manager activities. Generally, each SRO proposes that firms implement written policies and procedures reasonably designed to independently supervise the customer account activity conducted by branch office managers, sales managers, regional or district sales managers, or any person performing a similar supervisory function. The proposed amendments clarify that such reviews be conducted by a "qualified person" with the requisite supervisory qualifications license, provided such person is senior to the producing manager under review. Notably, while both SRO amendments clarify that someone who is "senior" to the producing manager must conduct the reviews, the reference to "qualified" individuals appears only in the NYSE Rule 342.19. NASD's companion Rule 3012 has no such reference.

A. Independent Supervision

Overall, the Committee generally supports these changes as a step in the right direction toward addressing many of our initial concerns. However, we believe the stipulation that someone "senior" to the producing manager conducts the supervision is too narrow in scope since it effectively negates supervisory review by otherwise capable individuals. Because of the diversity of firms' business models and reporting line structures, we think a blanket rule that looks only to the supervisor's position in the firm's organizational chart without regard for actual authority or "independence" to be unreasonable. Indeed, there are many instances where individuals at equal levels of "seniority" within the firm are sufficiently "independent" and armed with the requisite authority to satisfy the rules' objectives. For example, many firms have administrative or other managers within the branch office structure that currently are assigned the responsibility of reviewing Branch Office Manager ("BOM") activity. In most cases, these individuals have little or no involvement in the transactions under review and fall outside the particular producing manager's reporting line. These individuals, typically of comparable standing to the BOM, often possess the requisite authority to review and act upon misconduct, if any, by a producing manager without fear of reprisal by the BOM. Under the current proposal, however, these individuals would be precluded from continuing in this role simply because they may not be deemed "senior" to the BOM. Such a rule, we believe, adds little to the objectives of investor protection while potentially subjecting firms to needless retooling of effective supervisory systems already in place.

For these reasons, we respectfully request the SROs reconsider the "seniority" requirement in order to give firms flexibility to utilize and build upon already existing,

proven supervisory processes without the need for costly systems' reconfiguration and redrafting of policies.

B. Heightened Supervision

In addition to the general supervisory review of manager activity discussed above, the NASD's proposed amendments provide an added layer of "heightened supervision" over the activities of a producing manager responsible for generating 20% or more of the income of the producing manager's supervisor.⁵ Although NASD does not mandate the elements of the heightened supervision procedures, the rule proposal explains that heightened supervision means "supervisory procedures that evidence supervisory activities designed to avoid economic, commercial, or financial related conflicts of interest that the supervisor may have with the associated persons and businesses being supervised." While we appreciate and commend NASD's efforts in seeking a more workable alternative to the initial proposal, we find this aspect of the proposal unduly complicated and potentially cumbersome in application.

Given the complexity of compensation structures within member firms, and the fact that compensation income is volatile month-to-month and year-to-year, we believe that managing and tracking the 20% threshold will be unduly cumbersome and costly. We also question whether this provision remains necessary, particularly in light of member firms' existing internal control and supervisory obligations, including those proposed on subsection A above. Accordingly, we respectfully recommend that the NASD reconsider the heightened supervision requirement in this situation.

Alternatively, should the Commission determine that the NASD proposal is appropriate, we urge that NASD provide additional guidance on how firms must compute the proposed 20% threshold. Specifically, the current form of the proposal does not specify how often firms must make this assessment (e.g. annually, semi-annually, quarterly) or what types of "income" are covered by the rule. For example, it is unclear whether the 20% threshold applies to gross or net income. Nor does the rule define the categories of income firms must include in the calculation (i.e., salary, commission, bonus, non-cash), or the extent to which firms must break down team awards affecting the producing manager's supervisor's income. Therefore, we recommend that NASD clarify the following for purposes of the heightened supervision requirement:

- The member firm's calculation of the supervisor's income shall be based on gross cash compensation attributable to the purchase and sale of securities, inclusive of base salary, commission and bonus only; and
- Firms should calculate the 20% threshold on an annual basis. This will more accurately identify true financial interdependency, if any, between the supervisor and producing manager. Annual calculation also would minimize the cost and potential

⁵ See proposed NASD Rule 3012(a)(2)(C).

confusion resulting from frequently adding and/or removing individuals from heightened supervision. Moreover, because firms typically determine income at fiscal year-end, an annual calculation may permit firms to utilize existing systems with minimal need for additional measures.

In all events, and consistent with provision governing annual reporting requirements, we recommend that the NASD similarly adopt a provision that deems compliance with the NYSE rules governing supervision of producing managers to be sufficient.

II. Branch Office Examination

NASD's amended proposal also would require that members establish heightened inspection procedures in situations where the person conducting the inspection either works in an office supervised by the branch office manager's supervisor or reports to the branch office manager's supervisor and the branch office manager generates 20% or more of the supervisor's income.⁶ For the same reasons articulated in Section I above, we urge NASD to reconsider the heightened inspection procedures component of the rule.

III. Supervisory Controls and Independent Testing and Verification

Proposed NASD Rule 3012 would require each member to establish supervisory control procedures that: (1) test and verify that the member's supervisory procedures are reasonably designed to achieve compliance with applicable federal securities laws and regulations and NASD rules; and (ii) amend the supervisory procedures where testing and verification identifies the need to do so. As originally proposed, NASD Rule 3012 further required that the supervisory control procedures be performed by persons who are "independent" from the activities being tested and verified and from the persons who directly supervise those activities. The amended proposal to Rule 3012.13 eliminates the "independent" provision, and replaces it with a requirement that firms designate and specifically identify to NASD the principal(s) responsible for establishing, maintaining and enforcing the supervisory procedures.

The Committee generally supports this modification as well. Due to the widely varied organizational structures and reporting lines that exist in NASD member firms, we recommend the NASD afford firms the flexibility to designate the individual or groups of individuals responsible for any one, or combination of, the different functions relating to the firms' supervisory controls and procedures. For example, it is not uncommon for one person or group of individuals within a firm to be responsible for establishing and maintaining the testing and verification processes, while another is assigned the task of enforcing such processes. Flexibility in application enables firms to expand upon already pre-existing testing and verification processes within their organizations while avoiding needless interruption, burdens and costs.

⁶ Proposed NASD Rule 3010(c)(3)

Finally, the Committee also continues to believe the specific activities set out in proposed NYSE Rule 401(b) and NASD proposed Rule 3012(a)(2)(B) should apply to retail customer activity generally, with limited, if any, application to institutional business. Institutional trading processes, systems and controls remain markedly distinct from retail account servicing. In recognition of these differences, we continue to urge the Commission to allow firms to tailor their policies and procedures in recognition of the fact that such procedures, while addressing the various regulatory obligations, may not be as extensive for institutional business as compared to those designed solely for retail clients.

IV. Time and Price Discretion

Both NYSE and NASD amendments also contain revisions governing time and price discretion within the context of institutional orders. Specifically, the SROs confirm that generally, time and price discretionary authority is limited to the day it is granted, absent written authorization to the contrary.⁷ However, with respect to institutional Good-Till-Cancelled (“GTC”) instructions issued on a “not-held” basis, the SROs provide for a limited exemption to the written authorization requirement.⁸ Unlike the NASD amendment, however, the NYSE provision applies only to time and price discretion provided or “transmitted to” NYSE Floor brokers.

Although clearly improved over the initial proposal, we still find the NYSE modifications to be problematic. By limiting the institutional exemption to orders provided solely to Floor brokers, we are concerned the NYSE amendment may inadvertently create a regulatory disincentive for firms to access other marketplaces for purposes of seeking best execution of their customers’ orders. In other words, the NYSE proposal essentially makes the NYSE the only forum in which to satisfy the institutional customer’s instruction that the firm work the order on a “not held” basis until cancelled, thereby removing any discretion granted to upstairs traders to determine the most favorable market for the GTC order. This result would not comport with the interests of investor protection or the policies underlying broker-dealers’ best execution obligations. Indeed, from a practical perspective, we believe that institutional investors are unlikely to agree to execution in any one marketplace as a condition of entering their orders.

In light of the forgoing, we respectfully request that the Commission require the NYSE to modify Rule 408 to expand the provision governing institutional orders provision to include other marketplaces, and simply not to orders provided to NYSE Floor brokers.

⁷ Proposed NASD Rule 2510(d)(1) and NYSE Rule 408(d).

⁸ Id.

V. Conclusion

The Committee fully supports the objectives of the NYSE and NASD to have internal control requirements that enhance the effectiveness of member firms' supervisory systems as a meaningful protection against fraud and abuse. The Committee urges the Commission to consider the alternative approaches proposed above so that firms can meet these obligations with internal resources by building upon existing supervisory structures.

If you have any questions, or would like to discuss our comments further, please contact the undersigned or Amal Aly, Vice President and Associate General Counsel, at 212-618-0568.

Sincerely,

John Polanin Jr.
Chairman
Self-Regulation and
Supervisory Practices Committee

CC: Annette Nazareth, Director, Division of Market Regulation, SEC
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