

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

NASD is proposing to adopt new NASD Rule 3012 and amend other rules regarding the supervisory and supervisory control procedures of member firms. Below is the amended text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

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2510. Discretionary Accounts

(a) through (c) No change.

(d) Exceptions

This Rule shall not apply to:

(1) discretion as to the price at which or the time when an order given by a customer for the purchase or sale of a definite amount of a security shall be executed, *except that the authority to exercise time and price discretion will be considered to be in effect only until the end of the business day on which the customer granted such discretion, absent a specific, written contrary indication signed and dated by the customer. This limitation shall not apply to time and price discretion exercised for orders effected with or for an institutional account, as defined in Rule 3110(c)(4), pursuant to valid Good-Till-Cancelled instructions issued on a "not-held" basis;*

(2) No Change.

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

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3010. Supervision

(a) Supervisory System

Each member shall establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with *applicable NASD Rules* [the Rules of this Association]. Final responsibility for proper supervision shall rest with the member. A member's supervisory system shall provide, at a minimum, for the following:

(1) through (7) No change.

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

securities laws and regulations, and with the Rules of this Association.]

(b) No change.

(c) Internal Inspections

(1) Each member shall conduct a review, at least annually, of the businesses in which it engages, which review shall be reasonably designed to assist in detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations, and with *applicable NASD rules* [the Rules of this Association]. Each member shall review the activities of each office, which shall include the periodic examination of customer accounts to detect and prevent irregularities or abuses [and at least an annual inspection of each office of supervisory jurisdiction].

(A) *Each member shall inspect at least annually every office of supervisory jurisdiction and any branch office that supervises one or more non-branch locations.* [Each branch office of the member shall be inspected according to a cycle which shall be set forth in the firm's written supervisory and inspection procedures.]

(B) *Each member shall inspect at least every three years every branch office that does not supervise one or more non-branch locations. In establishing how often to inspect each non-supervisory branch office [such cycle], the firm shall [give consideration to] consider whether the nature and complexity of the securities activities for which the location is responsible, the volume of business done, and the number of associated persons assigned to the location require the non-supervisory branch office to be inspected more frequently than every three years. The non-supervisory branch office examination cycle and an explanation of the factors the member used in determining the frequency of the examinations in the cycle shall be set forth in the member's written supervisory and inspection procedures.*

(C) *Each member shall inspect on a regular periodic schedule every non-branch location. In establishing such schedule, the firm shall consider the nature and complexity of the securities activities for which the location is responsible and the nature and extent of contact with customers. The schedule and an explanation regarding how the member determined the frequency of the examination schedule shall be set forth in the member's written supervisory and inspection procedures.*

Each member shall retain a written record of the dates upon which each review and inspection is conducted.

(2) *An office inspection and review by a member pursuant to paragraph (c)(1) must be reduced to a written report and kept on file by the member for a minimum of three years, unless the inspection is being conducted pursuant to paragraph (c)(1)(C) and the regular periodic schedule is longer than a three-year cycle, in which case the report must be kept on file at least until the next inspection report has been written. The written inspection report must also include, without limitation, the testing and verification of the member's policies and procedures, including supervisory policies and procedures in the following areas:*

(A) *Safeguarding of customer funds and securities;*

(B) *Maintaining books and records;*

(C) *Supervision of customer accounts serviced by branch office managers;*

(D) *Transmittal of funds between customers and registered representatives and between customers and third parties;*

(E) *Validation of customer address changes; and*

(F) *Validation of changes in customer account information.*

(3) *An office inspection by a member pursuant to paragraph (c)(1) may not be conducted by the branch office manager or any person within that office who has supervisory responsibilities or by any individual who is supervised by such person(s). A member must have in place procedures that are reasonably designed to provide heightened office inspections if the person conducting the inspection reports to the branch office manager's supervisor or works in an office supervised by the branch manager's supervisor and the branch office manager generates 20% or more of the income of the branch office manager's supervisor. For the purposes of this subsection only, the term "heightened inspection" shall mean those inspection procedures that are designed to avoid conflicts of interest that serve to undermine complete and effective inspection because of the economic, commercial, or financial interests that the branch manager's supervisor holds in the associated persons and businesses being inspected.*

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(g) Definitions

(1) No change.

(2) (A) "Branch Office" means any location identified by any means to the public or customers as a location at which the member conducts an investment banking or securities business, excluding:

(A) through (D) renumbered as (i) through (iv).