

supervision" or "best practices" that could be tailored to various business models rather than "prescriptive rules that apply to firms across the board."

The Exchange does not agree that the proposed rules should be adopted in the form of "principles" or "best practices." The degree of authority carried by rules and their interpretations is deemed to be the appropriate impetus to encourage the conduct intended by the amendments. However, as discussed in detail below, the Exchange agrees that greater flexibility is needed in certain respects to account for variations in member organization business models.

#### Independent Supervision of Managers' Activity

Proposed NYSE Rule 342.19 requires written policies and procedures reasonably designed to independently supervise the customer account activity of Sales Managers. The Commenters seek clarification of the "independence" standard. It is contended that individuals within a firm at equal or higher organizational levels, peripherally involved, or who receive an indirect benefit from the activity being reviewed may, nevertheless, have sufficient independence to perform this function.

In response, the proposed amendments to NYSE Rule 342.19 have been revised to provide greater flexibility by clarifying that reviews of Sales Managers' customer activity may be conducted by a "qualified person," provided such person is senior to the manager (*i.e.*, not the manager him/herself, or any person with the same job function as such manager,<sup>10</sup> or any person subordinate to the manager). The proposed rule has also been revised to make clear that the "qualified person" standard, in the context of NYSE Rule 342.19, is defined by NYSE Rule 342.13, which requires passing specified supervisory qualification examinations (*e.g.*, Series 9/10).

#### Supervisory Controls and Independent Testing and Verification

Proposed NYSE Rule 342.23 requires members and member organizations to develop adequate controls over each of their business activities. The Rule further requires that such controls provide for the establishment of procedures for independent verification and testing of those business activities. The Commenters sought clarification as to who would be sufficiently

"independent" to perform these "verification and testing" functions.

While Commenters acknowledge that supervisors lack sufficient independence to verify and test procedures they personally implement, flexibility to accommodate a variety of supervisory structures beyond self-supervision is sought. Commenters contended that senior supervisors in a hierarchical supervisory structure should not be excluded because they may derive an "indirect benefit" from the activity under review.

The Exchange recognizes the far-ranging scope and variety of activities subject to the verification and testing requirements. Accordingly, the requirement that internal control procedures be "separate and apart from the day-to-day supervision of such functions" has been deleted from the proposed amendments to NYSE Rule 342.23 to allow greater flexibility in establishing such internal controls. However, firms will be expected to make an informed determination that persons responsible for verification and testing of business activities are sufficiently independent and qualified to do so effectively.

Commenters also seek clarification and assurance that the proposed requirements do not create an obligation for firms to annually test and verify "every aspect" of their supervisory procedures but rather allow for a "risk-based approach" based upon ongoing assessments of the firm's business.

In response, the proposed amendments to NYSE Rule 342.23 have been revised to allow for an ongoing analysis, based upon appropriate criteria, to assess and prioritize those business activities requiring independent verification and testing.

#### Designated Internal Control Requirements

Proposed NYSE Rule 401(b) ("Business Conduct") requires that written policies and procedures, administered pursuant to the internal control requirements prescribed under proposed NYSE Rule 343.23, must specifically address transmittals of funds between accounts, changes in investment objectives, and changes of address. These designated policies and procedures must include a means/method of customer confirmation, notification, or follow-up that can be documented.

The SIA has proposed that these requirements should apply only to retail accounts. An "institutional carve-out" is sought, given that much of such business is done DVP or through Prime Brokerage accounts.

The Exchange believes that an exemption for institutional accounts is inappropriate. In order for an internal controls policy to be effective, it must be comprehensive. Accordingly, it is reasonable and appropriate that regulatory oversight in the sensitive areas designated in proposed NYSE Rule 401(b) should extend to institutional account activity.

#### Time and Price Discretion

Proposed amendments to paragraph (d) of NYSE Rule 408 ("Discretionary Power in Customers' Accounts") require that time and price discretionary authority be limited to the day it is granted, absent written customer authorization to the contrary.

Commenters suggest consideration of an "institutional exemption" from the requirement on the basis that requiring such written authorization would be inconvenient and unnecessary for sophisticated institutional clients who do not need the same level of protection as retail clients. Such clients are accustomed to entering orders that are "worked" over one or more days on a Good-Till-Cancelled/Not Held basis.

The Exchange believes that a general institutional exemption is inappropriate. However, the amendments have been revised to clarify that written authorization need not be obtained for the exercise of time and price discretion beyond the day a customer grants such discretion for orders exercised by Floor brokers pursuant to valid Good-Till-Cancelled instructions issued on a "not held" basis.

In addition, Commenters seek clarification as to whether the written authorization for the exercise of time and price discretion beyond the business day it was granted need be obtained on an "order-by-order basis," or whether general "standing instructions" from the customer are permitted.

The current text of NYSE Rule 408(d) clearly limits the exercise of time and price discretion to "the purchase or sale of a definite amount of a specified security. \* \* \*." Any written authorization granting time and price discretion must comply with this established, trade-specific standard. Customers who wish to grant more extensive discretionary authority to their registered representative may do so pursuant to a fully executed trading authorization.

#### Maintenance of "Account Designation Change" Documentation

The proposed amendments to NYSE Rule 410 ("Records of Orders") state, in

<sup>10</sup> Telephone conversation between Steve Kasprzak, Attorney, NYSE and Jennifer Colihan, Special Counsel, Division of Market Regulation, Commission, on August 7, 2003.