



NASAA

10 G Street N.E., Suite 710  
Washington, DC 20002  
2021737-0900

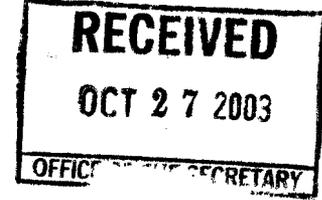
Fax: 202/783-3571

E-mail: info@nasaa.org

Web Address: http://www.nasaa.org

October 24, 2003

Jonathan Katz  
Secretary  
U.S. Securities and Exchange Commission  
450 5<sup>th</sup> Street  
Washington, DC 20002



RE: SR-NASD-2002-162 and SR-NYSE-2002-36 Notice of Filing of  
Amendments to proposed Rule Change by NASD and NYSE Relating to  
Supervisory Control Amendments

Dear Mr. Katz:

Please accept NASAA's<sup>1</sup> comments to the above referenced rule change filings submitted to the U.S. Securities and Exchange Commission (the "Commission") by the NASD and NYSE. The rules are designed to further protect customers of NASD and NYSE firms from being defrauded by a trusted securities agent as they were recently by Frank Gruttadauria by enhancing firm supervision.

*Background – Congressional Findings*

Frank D. Gruttadauria perpetrated a massive fraud on more than 50 customers and misappropriated millions of dollars over a 15-year period starting in 1987, with amounts exceeding \$40 million in the last seven years alone. Gruttadauria lied to these customers about the holdings in their accounts, overstating the value of their accounts by over \$275 million as of the end of 2001.<sup>2</sup> The fact that Gruttadauria carried out this fraud while working as a branch manager at various times for several Wall Street firms, combined with the failure of these firms' internal supervisory systems to detect and prevent such a massive fraud alarmed the public, the regulators and the United States Congress.

On May 23, 2002, the Subcommittee on Oversight and Investigations of the House Financial Services Committee, chaired by the Honorable Susan Kelly, held the first Congressional hearing to examine the activities of Gruttadauria. The goals of the

<sup>1</sup> The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc., was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico and Puerto Rico. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

<sup>2</sup> SEC Litigation Release No. 17369/ February 21, 2002

hearing were to determine the extent of the losses suffered by his clients, and why Gruttadauria's activity was not detected and stopped<sup>3</sup>.

At the hearings, the SEC, the NYSE, the NASD, and NASAA pledged their cooperation on placing more emphasis on tougher enforcement. The hearings also made it clear that appropriate efforts need to be undertaken by the SEC and the SROs to ensure improvements in information sharing through revisions in relevant rules, regulations and guidelines against disreputable activities by broker/dealers and their agents.

### *November 20, 2002 proposed rulemaking*

On November 20, 2002, in reaction to the Congressional hearings, the NASD and NYSE released proposals intended to enhance rules regarding the supervisory and supervisory control procedures of their member firms. The NASD proposed the addition of a new rule 3012. The rule would require members to develop both general and specific supervisory control procedures that independently test, verify and, where necessary, modify the members' supervisory procedures.

In addition, the NASD proposed amendments to current rules that (1) would require that office inspections be conducted by "independent" persons and include, at a minimum, the testing and verification of certain supervisory procedures; (2) expand upon a member's supervisory and recordkeeping requirements with respect to changes in customer account name or designation in connection with order executions; (3) provide guidance as to when a member may hold mail for a customer who will be absent for a period of time; (4) would clarify the time limit on time-and-price discretionary authority; and (5) would incorporate into NASD Procedural Rules the ability of members to request an exemption from amended NASD Rule 3010(c).

The NYSE proposals included the addition of paragraph .23 to NYSE Rule 342 ("Offices - Approval, Supervision and Control") which addressed internal control requirements generally, as well as amendments to Rule 401 ("Business Conduct") which identified and required specific internal control safeguards related to the transmission of customer funds and securities, and changes of customer address.

The proposals also addressed related supervision and/or control issues that were encompassed in the Exchange's review including amendments to: NYSE Rule 342 ("Offices - Approval, Supervision and Control") that would require systems and procedures to independently supervise sales managers who handle customer accounts; NYSE Rule 408 ("Discretionary Power in Customers' Accounts") that would clarify time limits on time-and-price discretionary authority; NYSE Rule 410 ("Records of Orders") that would expand the Rule's application and clarify its supervisory and recordkeeping provisions; and to the Interpretation of NYSE Rule 342 that would require persons who

---

<sup>3</sup> See H.R. REP. 107-798, REPORT ON THE ACTIVITY OF THE COMMITTEE ON FINANCIAL SERVICES FOR THE 107TH, HOUSE REPORT NO. 107-798 January 2, 2003

conduct branch office inspections to be independent of such office's ongoing supervision, control, or performance evaluation.

*August 7, 2003 amendments to proposed rulemaking*

In reaction to letters commenting upon the November 20, 2002 proposal the NASD and NYSE released amendments to their proposals on August 7, 2003. These amendments, in large part, allow for greater flexibility to account for variations in members' business models. The proposed amendments remove the requirement from the proposed new NASD rule 3012 that the person establishing, maintaining and enforcing supervisory control policies and procedures be "independent" and replaces it with a requirement that the member need only identify to the NASD one or more principals who will be charged with the above mentioned tasks concerning supervisory control procedures.

The NASD amendments also remove the requirement that an independent party conduct the branch office inspections. In its place, the amendments prohibit the branch office manager, any one who has supervisory responsibilities, or any one who is supervised by the branch manager's supervisor, from conducting the office inspection. The rule would also require 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 that branch office manager generates 20% or more of their supervisor's income. These heightened procedures might include unannounced office inspections, increased frequency of inspections, a broader scope of activities inspected, and/or having one or more principals review and approve the office's inspections.

The 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. The NYSE 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.

The NYSE deleted from NYSE Rule 342.23 the requirement that internal control procedures be "separate and apart from the day-to-day supervision of such functions," 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.

The NYSE also altered its proposed requirement that someone independent of the branch conduct branch office inspections. The NYSE proposed amendment does not exclude all participants at every level of a branch office's hierarchical supervisory structure from conducting inspections, but the NYSE believes it is reasonable that the firm exclude the branch manager, any person to whom the branch manager directly reports, and any person who reports to the branch manager.

Both the NASD and NYSE also explained that they would not alter the proposed rule in certain areas recommended by the industry. One commentator urged that the rules should be converted into “principles for effective supervision” or “best practices.” The SROs responded that the degree of authority carried by the proposed rule is necessary to encourage the conduct intended by the rule changes. Another commentator complained that the books and records requirement that only a principal may change account names or designations would be costly. The SROs responded that it understood the rule might be costly, but account names and designations are material information that must be protected from fraudulent conduct.

### *Discussion*

Firm supervision is the front line defense to prevent fraud against its customers. Regardless of the effectiveness of state, federal and SRO examination programs, they cannot detect every occurrence of fraud at remote office locations throughout the country. The Gruttadauria case, while large in its scope, is not unique. The hundreds of cases brought each year by state securities regulators against firms for failure to implement adequate supervisory policies and procedures have long provided clear evidence that firm supervisory practices have been in need of augmentation. The progressive increase in the number of these actions make clear that regulations are needed that encourage firms to implement meaningful supervisory policies and procedures. Such regulations would require firms to ensure that senior employees are tasked with the responsibility of assuring the accuracy of the account information records which are so easily manipulated. NASAA believes that the proposed rules will enable firms to significantly increase their likelihood of detecting such fraudulent schemes before retail investors lose their life savings. The proposed rules also provide firms with enhanced mechanisms by which they may uncover ongoing fraudulent conduct and to prevent such future conduct.

### *NASAA Position*

NASAA agrees with the NASD and the NYSE of the necessity that these proposed amendments be codified as rules rather than left as “best practices.” The fact that NASD and NYSE have amended the proposals to allow firms to shape their supervision programs around their business models provides ample comfort to the firms. The fundamental compliance principles guiding these rules are straightforward. One principle is the integrity of the internal audit. In essence, the firm must assure that the inspections are independent in the sense that the auditor is neither intimidated by nor financially connected to the person who has authority over the subject of the audit. To this end, the NASD and NYSE should clarify that the person responsible for the inspection of a branch office cannot report directly or indirectly to the sales manager of the branch office and any report generated by such person will be sent to the compliance department directly and then delivered to the branch office.

*NASAA Position on Related Rule 3010*

A second fundamental compliance principle is the accountability of principals for their supervisory processes. To that end, NASAA believes the Commission should also focus its attention on NASD Special Notice to Members to amend NASD Rule 3010 to require CEOs and CCOs to certify that broker-dealers have adequate compliance and supervisory policies and procedures. These proposed rule changes, which are not incorporated into the changes currently before the Commission, enhance compliance and supervision by (1) requiring regular reviews of compliance and supervisory procedures, and (2) fostering regular and significant interaction between senior management and chief compliance officers. The CEO certification requirement will lead to more focused and thoughtful review of compliance and supervisory procedures by senior management, and it will prompt senior management to solicit more input from the compliance officers at each firm.

For too long, senior management at broker-dealer firms have paid too little heed to compliance departments, which do not generate revenue. The CEO certification will provide another incentive for CEOs to consider compliance implications, not just the bottom line, when they evaluate new business plans, especially those that involve the sale of complex or high-risk products to retail investors. We **think** that the rule changes currently before the SEC, which essentially identify who at the firm should be responsible for the internal audits and controls, are incomplete if they do not place ultimate responsibility for compliance and supervision on the top decision maker of the firm. Approval of the NASD CEO certification rule will fill that void. This rule should also be applicable to NYSE firms.

As a last note, state statutes generally provide an Administrator with the right to take action against a broker dealer's license if the broker dealer fails to reasonably supervise their employees! The proposed rules will most likely encourage better supervision and decrease the number of remedial actions securities regulators may need to put in place.

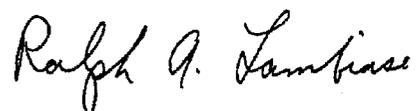
---

<sup>4</sup> See Uniform Securities Act of 1956 Sec. 204. [Denial, revocation, suspension, cancellation and withdrawal of registration.]

*Conclusion*

**NASAA** recommends the Commission approve the proposed rules because they will encourage firms to take more appropriate measures to protect their clients. The system of internal firm supervision controls kept in check by SEC, SRO, or state audits of the firms will be strengthened. Questions concerning this letter can be addressed to Rex Staples, at Washington's Department of Financial Institutions at (360) 902-8734 or John Veator, at NASAA's General Counsel's office at (202) 737-0900.

Sincerely,

A handwritten signature in cursive script that reads "Ralph A. Lambiase".

Ralph A. Lambiase  
NASAA President and  
Director, Connecticut Division of Securities