

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-53689; File No. SR-NYSE-2005-60)

April 20, 2006

Self-Regulatory Organizations; New York Stock Exchange, Inc. (n/k/a New York Stock Exchange LLC); Notice of Filing of Proposed Rule Change and Amendment No. 2 Thereto Relating to Proposed New Rules 342.24 (“Annual Branch Office Inspection”) and 342.25 (“Risk-Based Surveillance and Branch Office Identification”) to Permit Member Organizations to Classify Appropriate Branch Offices for Cyclical Inspections and Proposed New Rule 342.26 (“Criteria for Inspection Programs”)

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 August 15, 2005, the New York Stock Exchange, Inc.³ (n/k/a New York Stock Exchange LLC) (“Exchange”) 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 the Exchange. The Exchange filed Amendment No. 2 to the proposed rule change on April 7, 2006.⁴ The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

The Exchange is filing with the Commission proposed new Exchange Rules 342.24 (“Annual Branch Office Inspection”) and 342.25 (“Risk-Based Surveillance and Branch Office Identification”) to permit organizations to classify appropriate branch offices for cyclical

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ The Exchange is now known as the New York Stock Exchange LLC. See Securities Exchange Act Release No. 53382 (February 27, 2006), 71 FR 11251 (March 6, 2006).

⁴ See Amendment No. 2.

The Exchange filed Amendment No. 1 to the proposed rule change on October 31, 2005 and subsequently withdrew Amendment No. 1 on April 7, 2006.

inspections and 342.26 (“Criteria for Inspection Programs”). The text of the proposed rule change is available on the Exchange’s Web site (<http://www.nyse.com>), at the Exchange’s Office of the Secretary, and at the Commission’s Public Reference Room.

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

In its filing with the Commission, the Exchange 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. The Exchange 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

The proposed amendments would permit member organizations, with the written approval of the Exchange, to exempt certain branch offices from the general annual branch office inspection requirement of Exchange Rule 342 (“Offices – Approval, Supervision and Control”) by utilizing an Exchange-approved risk-based surveillance system.⁵ In addition, the proposed amendments would re-position a portion of Exchange Rule 342’s Interpretation into the rule text.

The purpose of the proposed amendments is to provide member organizations the flexibility to reduce unnecessary inspections of low-risk branch offices with good compliance

⁵ Pursuant to discussions with Exchange staff, the Commission made clarifying changes to the purpose section of the proposed rule change. Telephone conversations between Stephen Kasprzak, Principal Counsel, Rule and Interpretative Standards, Exchange, and Cyndi N. Rodriguez, Special Counsel, and Kate Robbins, Attorney, Division of Market Regulation (“Division”), Commission, on April 18, 2006.

records and to more fully concentrate surveillance and compliance resources on those branch offices that would most likely benefit from more frequent or more thorough on-site inspections. This would be accomplished through the ongoing monitoring of prescribed branch office criteria that would serve as effective indicators to distinguish those offices that warrant annual inspection from those that might not. Further, use of the prescribed criteria would enable member organizations to more effectively direct attention to those regulatory risk areas most likely in need of closer scrutiny during the course of an on-site inspection. The proposed amendments would require that every branch office, without exception, be inspected at least once every three calendar years.

Background

Exchange Rule 342 and its Interpretation currently require that branch office inspections be conducted at least annually by member organizations, unless it has been demonstrated to the satisfaction of the Exchange that because of proximity, special reporting or supervisory practice, other arrangements may satisfy the Rule's requirements.⁶ Under this Interpretation, exemptions from the general annual inspection requirement have been determined on case-by-case basis, one branch office at a time. Recent years have brought to the securities industry an increase in the number of smaller, so-called "limited purpose offices,"⁷ as well as many life-style changes (such as increasing use of home offices). These business/demographic changes, coupled with advances in the use of surveillance technology, strongly suggest that it may be no longer practicable or necessary that all branch offices warrant on-site annual inspections.

⁶ Interpretation Handbook Rule 342(a),(b)/03 ("Annual Branch Office Inspection").

⁷ See Securities Exchange Act Release No. 52640 (October 19, 2005), 70 FR 61672 (October 25, 2005) (SR-NYSE-2004-51).

The provision, noted above, allowing for a case-by-case exemption from the annual inspection requirement is being retained. However, in order to provide a more uniform standard to determine such exemptions, and in recognition of available surveillance capabilities, proposed Exchange Rule 342.24 would permit member organizations to submit to the Exchange, for approval, policies and procedures outlining the use of a risk-based surveillance system that the firm would utilize to identify branch offices requiring less frequent than annual inspections. The proposed amendments would require that all branch offices, without exception, be inspected at least once every three calendar years.

Policies and Procedures

Under the proposed amendments, a member organization seeking an exemption from the standard annual inspection requirement would be required to submit to the Exchange policies and procedures that reflect their business models and product mix. In addition to the incorporation of prescribed criteria to identify branch offices eligible for exemption from an annual inspection cycle (discussed in detail below), proposed Exchange Rule 342.25 would outline the policy and procedure requirements that member organizations would be required to include in any risk-based surveillance system acceptable to the Exchange pursuant to the proposed amendments. Specifically, such policies and procedures would be required to provide, at a minimum, for: 1) flexibility to initiate “for-cause” inspections, when circumstances warrant, of any branch office that has been exempted from the standard annual inspection cycle; 2) inspection on an unannounced basis of no less than half of the branch offices inspected each year; and 3) a system to allow employees to report compliance issues on a confidential basis outside of the branch office chain of command.

The Exchange believes that establishment of these policy and procedure requirements would engender an environment conducive to effective supervision and oversight by member organizations of both branch offices subject to an annual inspection cycle as well as those exempted from the standard cycle. For instance, the requirement that “for-cause” inspections be conducted when warranted makes clear that branch offices that have been deemed exempt from the standard annual inspection cycle are not exempt from ongoing surveillance and supervision.⁸ Further, if the profile of an exempted office subsequently changes (with respect to the size or scope of its business activities or significant changes in other risk-based criteria), the firm could reconsider the exemption. In instances where a firm rescinds an exemption from annual branch office inspection due to regulatory “red flags” (e.g., registered representatives under special supervision, receipt of multiple customer complaints, etc.), the rescission should remain in effect until the factors or conditions that prompted it have been thoroughly resolved.

The use of unannounced branch office inspections is an effective means of enhancing the integrity of the annual inspection process in that it encourages branch office personnel to properly view regulatory compliance as an ongoing, day-to-day process.⁹

The ability of employees located in branch offices to report compliance issues on a confidential basis outside of the branch office chain of command should foster an atmosphere conducive to reporting issues of regulatory concern that may arise at the branch level, but might not be reflected in the prescribed risk criteria. Knowledge of such compliance issues would further assist firm personnel in making “for-cause” branch office inspection determinations.

⁸ But see also Section 15(b)(4)(E) of the Act, 15 U.S.C. 78o(b)(4)(E).

⁹ The Division’s Staff Legal Bulletin No. 17 (Remote Office Supervision) noted that unannounced inspections may form part of an effective supervisory system.

Prescribed Criteria

Certain prescribed criteria, applied to each branch office, would be required of any acceptable risk-based surveillance system used to determine which branch offices could be exempted from annual inspection. The criteria, selected after extensive review by Exchange staff and consultation with industry representatives, are effective indicators to distinguish those offices that warrant annual inspection from those that might not. Further, their inclusion directs attention to the risks that most need to be addressed via on-site inspection. The risk-based factors to be considered should include, but not necessarily be limited to, the following:

- (1) Number of registered representatives;
- (2) A significant increase in the number of registered representatives;
- (3) Number of customers and volume of transactions;
- (4) A significant increase in branch office revenues;
- (5) Incidence of concentrated securities positions in customers' accounts;
- (6) Aggregate customer assets held;
- (7) Nature of the business conducted and the sales practice risk to investors associated with the products sold, and product mix (e.g., options, equities, mutual funds, annuities, etc.);
- (8) Numbers of accounts serviced on a discretionary basis;
- (9) Compliance and regulatory history of the branch, including:
 - (a) Registered representatives subject to special supervision by the member organization, self-regulatory authorities, state regulatory authorities or the SEC in years other than the previous or current year;
 - (b) Complaints, arbitrations, internal discipline, or prior inspection findings; and

- (c) Persons subject to recent disciplinary actions by self-regulatory authorities, state regulatory authorities or the SEC.
- (10) Operational factors, such as the number of errors and account designation changes per registered representative;
- (11) Incidence of accommodation mailing addresses (e.g., post office boxes and “care of” accounts);
- (12) Whether the branch office permits checks to be picked up by customers or hand delivery of checks to customers;
- (13) Experience, function (producing or non-producing) and compensation structure of branch office manager;
- (14) Branch offices recently opened or acquired; and
- (15) Changes in branch location, status or management personnel.

The size of the office (as represented by the number of registered representatives, the number of customers, the volume of transactions and the aggregate customer assets held), as well as any significant increase in the number of registered representatives or revenues, are quantitative considerations that a firm should carefully assess before granting an exemption from the annual inspection. Either individually or in aggregate, these factors could indicate that the office’s activity is so extensive that, as a matter of good practice, it should be inspected annually, even in the absence of any disciplinary or operational “red flags.” In fact, as discussed below, certain quantitative thresholds would, in and of themselves, disqualify offices from an annual inspection exemption.

The incidence of concentrated securities positions in customers’ accounts is included since highly concentrated positions, particularly in securities not recommended by the firm,

could be indicative of unsuitable or highly leveraged activity. The nature of the business conducted and the sales practice risk to investors associated with the products sold and product mix of the branch office would be factors to consider, as would the prevalence of certain types of investment strategies. For example, a high level of low-priced equities (e.g., penny stocks) might be indicative of potential sales practices problems. The numbers of accounts serviced on a discretionary basis would be a factor given the heightened potential for abuse (e.g., churning or excessive trading) in such accounts.

As with all risk-based criteria, the factors noted above should not be viewed strictly in quantitative terms but should also be subjected to qualitative analysis when determining whether to exempt a branch from the annual inspection requirement. For example, while a branch office's increase in revenue may simply be attributable to an increase in the number of registered representatives it employs, it may also be attributable to increased sales volume from existing customers of registered representatives, which could be indicative of an inappropriately aggressive sales effort.

Also to be considered when conducting a branch office risk analysis is the compliance and regulatory history of the branch office. Such factors include:

- (1) Registered representatives subject to special supervision¹⁰ by the member organization, self-regulatory authorities, state regulatory authorities or the SEC in years other than the previous or current year;
- (2) Complaints, arbitrations, internal discipline, or prior inspection findings; and

¹⁰ Indicia of special or heightened supervision include, but are not limited to, limitation on the types of products (e.g., low price or small cap) a broker is permitted to sell, restrictions or elimination in a broker's discretion, restricting the broker to soliciting only firm recommendations, and approval of all or certain transactions prior to execution.

- (3) Persons subject to recent disciplinary actions by self-regulatory authorities, state regulatory authorities or the SEC.

In analyzing the compliance and regulatory history of branch offices, firms should, among other things, review the previous 12 months for investigations by any self-regulatory organization or the SEC, customer complaints or complaint summaries, arbitrations and lawsuits closed or pending, Form RE-3 filings submitted to the Exchange pursuant to Exchange Rule 351(a), and internal investigation reports filed pursuant to Exchange Rule 351(e).¹¹

It is expected that the review and analysis of recent branch office regulatory history would have a considerable effect on exemption determinations. For example, a significant disciplinary action at a given branch office location would strongly suggest against a firm granting an exception from an annual branch office inspection. Moreover, an overall increase in the number of disciplinary actions firm-wide should require the firm to review its overall inspection cycle, particularly regarding inspections on less than an annual basis.

As discussed further below, in instances where a branch office has one or more registered representatives subject to special supervision, it should subject that branch office to the annual inspection until such time as the registered representatives are no longer subject to such supervision. In instances where the conduct of a particular registered representative or that of the office generally has been egregious, the firm should take immediate and appropriate action and consider administering on-site inspections on a more frequent than annual basis.

¹¹ See Exchange Information Memo No. 06-6, dated February 17, 2006. See also note 5, supra.

In addition, the proposed amendments prescribe certain key operational factors to be considered when making determinations regarding the frequency of branch office inspections.

Specific indicators include:

- (1) The number of errors and account designation changes per registered representative (which can be indicative of unauthorized trading);
- (2) The presence of “accommodation” mailing addresses (e.g., post office boxes and “care of” accounts), which can be indicative of a registered representative directing confirms, statements, and other account-related materials to other than the customer; and
- (3) Whether the branch office permits checks to be picked up by customers or hand delivers checks to customers (a practice that could facilitate misappropriation practices).

These criteria reflect the focus of recent amendments to Exchange Rule 342 that subject certain sensitive regulatory functions to internal control procedures in order to address potential lapses in supervision at member organizations.¹² The referenced operational functions have been included due to their notable misuse, both by registered representatives and branch office managers (BOMs), to the disadvantage of customers. Accordingly, consistent with the general supervision requirements of Exchange Rule 342, a firm should carefully review such criteria, quantitatively and qualitatively, before granting an exemption from an annual inspection.

¹² See Exchange Information Memo 04-38, dated July 26, 2004. See also Securities Exchange Act Release No. 49882 (June 17, 2004), 69 FR 35108 (June 23, 2004) (SR-NYSE-2002-36).

The prescribed criteria further include indicia relative to the BOM, such as his or her experience (whether it is sufficient for the nature and volume of business required to be supervised), whether or not the BOM services customer accounts (which could take time away or otherwise detract from supervisory duties), and the BOM's compensation structure (e.g., whether he or she receives a substantial override from registered representatives' revenue that could lead to a conflict of interest) or whether the BOM's compensation is determined in part by the branch's compliance record.

Finally, the proposed amendments require member organizations to consider potential problems associated with branch offices that have been recently opened or acquired, as well as changes in branch office location, status or management personnel. Where firms have acquired branch offices through merger or acquisition, and where such branch offices have had regulatory problems, firms should consider initially subjecting such offices to annual inspections absent compelling reasons to the contrary. Moreover changes in personnel (e.g., the resignation or termination of a BOM) may warrant more diligent review before exempting such branch office from the annual inspection cycle.

Branch Offices Not Eligible for Exemption

Certain branch offices - given their size, the scope of supervisory activities, or other factors - would not be deemed appropriate for an exemption under the proposed amendments. For instance, offices exercising supervision over other branch offices, those with 25 or more registered individuals, and offices in the top 20% of production or customer assets at the member organization would not be eligible for exemption from the annual inspection requirement, nor would any branch office with a registered representative subject to special supervision in the current or immediately preceding year. Further, the proposed amendments require that every

branch office, without exception, be inspected at least once every three calendar years.

Repositioning of Interpretation Text

The proposed amendments would delete current Interpretation 342(a),(b)/03 in its entirety. However, the Interpretation text is largely being repositioned into the Rule itself. For instance, the proposed amendments retain: 1) the ability of a member organization to request, on an office-by-office basis, an alternate arrangement to an annual inspection; 2) the requirement that branch office inspections be carried out by a person independent of the branch office in question (i.e., not the Branch Office Manager, or any person who directly or indirectly reports to such Manager, or any person to whom such Manager directly reports); and 3) the requirement that internal controls over certain prescribed areas be subject to independent testing and verification.¹³ The amendments would also require that written reports reflecting the results of the inspections must be maintained for the longer of three years or until the next branch inspection.¹⁴

2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with the provisions of Section 6(b)(5) under the Act¹⁵ because it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect

¹³ See proposed Exchange Rule 342.26.

¹⁴ See proposed Exchange Rule 342.24.

¹⁵ 15 U.S.C. 78f(b)(5).

investors and the public interest. The Exchange believes that the proposed rule change is consistent with the Section in that it should enable member organizations to better allocate and focus their regulatory resources on their branches requiring annual inspections.

B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange believes that the proposed rule change will not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Comments were neither solicited nor received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

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 finding or (ii) as to which the Exchange consents, the Commission will:

- (A) by order approve such proposed rule change, as amended; or
- (B) institute proceedings to determine whether the proposed rule change, as amended, 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.

Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or

- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-NYSE-2005-60 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NYSE-2005-60. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). 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 also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that

you wish to make available publicly. All submissions should refer to File Number SR-NYSE-2005-60 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁶

Nancy M. Morris
Secretary

¹⁶ 17 CFR 200.30-3(a)(12).