SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51907; File No. SR-NYSE-2004-13)

June 22, 2005

Self-Regulatory Organizations; New York Stock Exchange, Inc.; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendments No. 2 and No. 3 Thereto to Adopt Rule 405A ("Non-Managed Fee-Based Account Programs – Disclosure and Monitoring")

I. Introduction

On February 25, 2004, the New York Stock Exchange, Inc. ("NYSE" or the "Exchange") filed with the Securities and Exchange Commission ("SEC" or the "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),[1] and Rule 19b-4 thereunder,[2] a proposed rule change to prescribe certain requirements for members and member organizations that offer programs that charge customers a fixed-fee or percentage of account value in lieu of commissions. On October 22, 2004, the NYSE filed Amendment No. 1 to the proposed rule change.[3] Notice of the proposed rule change, as amended by Amendment No. 1, was published for comment in the Federal Register on November 1, 2004.[4] The Commission received four comment letters in response to the proposed rule change.[5] On June 21, 2005, the NYSE filed Amendment No. 2 and Amendment No. 3 to the proposed rule.[6] This order approves the proposed rule change,

1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 See letter from Mary Yeager, Assistant Corporate Secretary, NYSE, to Katherine A. England, Assistant Director, Division of Market Regulation, Commission, dated October 22, 2004.

4 See Securities Exchange Act Release No. 50586 (Oct. 25, 2004), 69 FR 63424 ("Notice").

5 See letters to Jonathan G. Katz, Secretary, Commission, from: Ira D. Hammerman, General Counsel, Securities Industry Association, dated November 22, 2004 ("SIA Letter"); Rosemary J. Shockman, President, Public Investors Arbitration Bar Association, dated November 19, 2004 ("PIABA Letter"); Barbara Black, Co-Director, Jill I. Gross, Co-Director, and Bob Kim, Student Intern, Pace Investor Rights Project, dated November 22, 2004 ("PIRP Letter"); and Curt Bradbury, Chief Operating Officer, Stephens Inc., dated November 22, 2004 ("Stevens Letter").

6 See Form 19b-4 dated June 21, 2005 ("Amendment No. 2") and Form 19b-4 dated June 21, 2005

as amended. The Commission is granting accelerated approval of Amendment No. 2 and Amendment No. 3, and is soliciting comments from interested persons on those amendments.

II. Background and Description of Proposed Rule Change

According to the NYSE, members and member organizations of the NYSE are increasingly offering Non-Managed Fee Based Account Programs ("NFBA Programs") to their customers. NFBA Programs are agreements between a broker-dealer and a customer in which the customer is charged a fixed fee and/or a percentage of account value rather than transaction-based commissions.[7] Because of their fee structure, such arrangements may not be appropriate for customers who trade infrequently. To address the particular regulatory challenges presented by NFBA Programs, the NYSE proposed new Rule 405A.

A. General Disclosure Required

Proposed Rule 405A would require NYSE members to provide to each customer, prior to the opening of an NFBA Program account, a disclosure document describing the types of NFBA Programs available to the customer.[8] For each type of Program, the document must include sufficient information to enable a customer to make a reasonably informed determination as to whether the Program is appropriate for him or her. This information should include, at minimum, a description of the services provided, eligible assets, fees charged, an explanation of how costs will be computed and/or the provision of cost estimates based on hypothetical

---

("Amendment No. 3"). As discussed below, in response to commenters, in Amendment No. 2, the NYSE proposed to eliminate a requirement that its members provide customers with an annual disclosure document and that its members attempt to determine "projected customer costs." Amendment No. 2 also proposed to make several minor changes to clarify the rule as originally proposed. Amendment No. 3 corrected a non-substantive typographical rule text error included in Exhibit 5 of the Amendment No. 2 filing.

7 See proposed NYSE Rule 405A(6).

8 See proposed NYSE Rule 405A(1).

portfolios, any conditions or restrictions imposed, and a summary of the Program's advantages and disadvantages.

B. Opening of Accounts

Proposed Rule 405A would require NYSE members to make a determination, prior to opening an account in an NFBA Program, that such Program is appropriate for each customer taking into account the services provided, anticipated costs, and customer objectives.[9] In making such determination, cost would be an important factor, but not the only one, that a member should consider. NYSE members would be required to consider the overall needs and objectives of the customer when determining the appropriateness of an NFBA Program for that customer, including the anticipated level of trading activity in the account and non-price factors, such as the importance that a customer places on aligning his or her interests with those of the broker.

C. Monitoring of Accounts

Proposed Rule 405A would require NYSE members to establish and maintain systems and procedures to enable them to monitor, on an ongoing basis, transactional activity by customers in NFBA Programs.[10] These systems and procedures would need to include specific written criteria for identifying customers whose level of account activity may be inappropriate in the context of the customer's Program. The determination of appropriateness would take into consideration not only costs incurred, but also Program services, customer investment objectives, and customer preferences.

---

9 See proposed NYSE Rule 405A(2).

10 See proposed NYSE Rule 405A(3).

D. Review and Follow-Up

The proposed rule would require each NYSE member to maintain written procedures for contacting and following up with customers whose accounts are identified in the monitoring stage.[11] The timeframe for identifying such customers should be, at minimum, a rolling 12 month period, though more frequent contact would be required should circumstances warrant. While the proposed rule does not prescribe specific procedures for identifying, contacting, and following up with customers, the means (e.g., letter, phone call, or e-mail) and general content of any unwritten follow-up customer contact would have to be documented and retained in an easily accessible place.[12]

E. Applicability of Rule

Because proposed Rule 405A is intended to protect the interests of retail customers, it contains an exception for accounts opened on behalf of "Qualified Investors" as that term is defined in Section 3(a)(54) of the Act.[13] This exception is based on the assumption that such accounts are generally directed by persons that are financially sophisticated and thus better able to make informed decisions regarding the appropriateness of available NFBA Programs. The proposed rule also does not apply to any NYSE member that does not offer NFBA Programs to its customers.

F. Supplementary Material

Proposed Rule 405A contains supplementary material reminding NYSE members that they have an obligation, under NYSE Rule 405(1), to "use due diligence to learn the essential

---

11 See proposed NYSE Rule 405A(4).

12 The proposed rule would not alter any recordkeeping requirements imposed on broker-dealers by Rules 17a-3 and 17a-4 under the Act. 17 CFR 200.17a-3 and 17-4.

13 See proposed NYSE Rule 405A(5).

facts relative to every customer and every cash or margin account, including accounts in Non-Managed Fee-Based Account Programs, accepted or carried by such member organization."[14]

III. Summary of Comments on the Proposed Rule Change

The Commission received four comment letters on the proposed rule change.[15] Two comment letters generally supported the proposal,[16] although one of them thought that the proposed rule failed to address what this commenter viewed as the larger problems customers face with fee-based accounts.[17] Two comment letters opposed it.[18]

Two commenters objected to the requirement in the proposed rule that members determine "projected customer costs."[19] For example, one commenter argued that it would be "difficult and potentially misleading to project customer costs with any degree of accuracy."[20] The same commenter also contended that the disclosure document does not need to be delivered annually, and that it could be incorporated into existing account opening documentation.

One commenter suggested that the proposal should clearly state that members may consider representations by the customer regarding anticipated levels of trading activity when

---

14 See proposed Rule 405A (Supplementary Material).

15 See supra note 5.

16 See PIRP Letter and PIABA Letter.

17 See PIABA Letter (expressing concern regarding the proposed rule's silence regarding the suitability obligations of members when recommending outside investment advisers and the rule's failure to address the obligations of members to monitor the suitability of the activity within an NFBA Program).

18 See SIA Letter and Stevens Letter.

19 Id.

20 See SIA Letter (suggesting instead that members "explain how costs will be computed and/or provide cost estimates based on hypothetical portfolios"), and see also Stevens Letter (arguing that determining "projected customer costs" is "unduly burdensome" and a matter of "pure guesswork"). Another commenter recommended that a disclosure document be provided that would allow a customer "to compare the cost of a fee-based program with a commission-based program for a given level of transaction volume and asset mix." See PIRP Letter.

determining whether it is appropriate to open an account in an NFBA Program, even though that representation alone may not be determinative in cases where the NFBA Program offers a preferred level of services.[21] Another commenter criticized the proposed rule because, "by solely focusing on cost," the proposed rule "undervalues the attention given by a broker to his customer and the advice of the broker," including advice not to trade, when appropriate.[22]

Two commenters objected to the requirement that members establish and maintain systems and procedures adequate to monitor, on an ongoing basis, transactional activity by customers in NFBA Programs.[23] One of these argued that, given that activity levels may not be the only factor in determining whether an NFBA Program is appropriate for customers, the development of transactional monitoring systems would be of limited use.[24] Another commenter argued that the proposal's focus on the cost of transactional activity alone to identify customers for follow-up may create the presumption that certain customers should have been in different kinds of accounts.[25]

Two commenters objected to the annual review period for determining which customer accounts must be followed up with.[26] One of these commenters thought that the review period

---

21 See SIA Letter.

22 See Stephens Letter. See also SIA Letter and PIRP Letter (arguing that, while non-cost factors should play a role in determining whether a NFBA Program is appropriate for a customer, they should not be used to justify extreme payment differentials over pay-per-trade arrangements).

23 See SIA Letter and Stevens Letter.

24 See SIA Letter (arguing also that requiring each member to develop an "automated surveillance system" would be onerous and costly).

25 See Stevens Letter.

26 See SIA Letter and Stevens Letter.

should be 24 months.[27] The other commenter argued that it should be 36 months.[28] One commenter opined that once a customer account is identified in the monitoring stage as requiring follow-up, the proposed rule could imply that members would be required to follow up with the customer indefinitely regardless of whether the customer's account continues to be identified.[29]

Two commenters objected to the exception in the proposed rule for "Qualified Investors."[30] One argued that the exception should be expanded to include "accredited investors" or any institutional customer with at least $10 million invested in securities in the aggregate.[31] It also argued that the proposed rule should not include accounts managed by independent investment advisory firms because these accounts are "managed." The other commenter did not think pension plans with investment advisers should be excepted from the rule.[32]

IV. Amendment No. 2 to the Proposed Rule Change

In Amendment No. 2, the NYSE modified the proposal to address certain comments received concerning the proposed rule change.

A. General Disclosure Requirements

As originally proposed, NYSE Rule 405A would have required NYSE members to provide an annual disclosure document to customers with an NFBA Program account.[33] Concluding that such disclosure would, in many instances, be redundant, the NYSE omitted this

---

27 See SIA Letter.

28 See Stevens Letter.

29 See SIA Letter.

30 See SIA Letter and PIABA Letter.

31 See SIA Letter.

32 See PIABA Letter (arguing that many pension plans of medical clinics and professional practices have trustees that are not sophisticated enough to select an appropriate investment adviser).

33 See Notice, 69 FR at 63424.

requirement.[34] As originally proposed, the NYSE rule would also have required NYSE members to disclose "projected customer costs."[35] Responding to the concerns of two commenters,[36] the NYSE determined that "due to the varying nature of Program features as well as the uncertainty of prospective trading volumes, 'projected customer costs' may be a somewhat speculative standard." Amendment No. 2, therefore, eliminates this requirement and replaces it with the requirement that NYSE members provide "an explanation of how costs will be computed and/or the provision of cost estimates based on hypothetical portfolios."

B. Monitoring of Accounts

As originally proposed, the NYSE rule would have required NYSE members to develop systems and procedures that include "transaction parameters for identifying customer account activity that may be inconsistent with the Program costs incurred by the customers."[37] Amendment No. 2 eliminates the "transaction parameters" requirement and replaces it with a requirement that NYSE members develop systems and procedures that include "written criteria for identifying customers whose level of account activity may be inappropriate in the context of the customer's Program."[38] In making this change, Amendment No. 2 clarifies that it was not the NYSE's intention to require its members to develop or acquire an automated system to monitor their NFBA Program accounts.

---

34 Amendment No. 2. However, as a matter of good business practice, the NYSE strongly advises that any significant changes or updates in a member organization's menu of NFBA Programs be brought to the attention of existing customers to assist them in making a determination as to whether they are in a Program that best suits their current investment objectives.

35 See Notice, 69 FR at 63424-25.

36 See SIA Letter and Stevens Letter.

37 See Notice, 69 FR at 63424.

38 Amendment No. 2 notes that: "The determination of appropriateness should take into consideration costs incurred, Program services, customer investment objectives, and customer preferences."

C. Review and Follow-Up

As originally proposed, the NYSE rule would have required that NYSE members maintain written procedures for contacting and following up with customers for whom NFBA accounts might be inappropriate, at minimum, every 12 months.[39] Amendment No. 2 modifies the follow-up requirement period to a rolling 12 months. This change responds to the concern of one commenter that the original proposal could imply that members were required to follow up with flagged customers in perpetuity.[40] Amendment No. 2 now clarifies that subsequent contacts are to be based upon subsequent activity reviews (i.e., "as appropriate").[41]

V. Discussion

After careful consideration of the proposal and the comments received, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange,[42] and, in particular, the requirements of Section 6 of the Act[43] and the rules and regulations thereunder. The Commission finds specifically that the proposed rule change is consistent with Section 6(b)(5) of the Act,[44] in that the proposal is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

---

39 See Notice, 69 FR at 63425.

40 See SIA Letter.

41 Amendment No. 2 also gives "e-mail" as an example of a permissible means of customer contact.

42 In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

43 15 U.S.C. 78f.

44 15 U.S.C. 78f(b)(5).

Fee-based accounts have become more popular over the last several years as commission revenue has declined with the decrease in trading volumes. Such accounts can benefit broker-dealers by providing them with a steady stream of revenue that is less dependent on short-term fluctuations in trading activity. Such accounts can also benefit customers by removing an incentive for broker-dealers to encourage trading in an account to increase commission revenue. At the same time, however, such accounts are not appropriate for every investor. One concern raised by fee-based accounts is that customers are being inappropriately moved into these accounts when commission-based accounts would cost them less due to their low volume of trading. Another concern is that there is currently little or no monitoring and follow-up required with customers whose trading activity has changed over time and for whom a fee-based account is no longer appropriate.[45] The NYSE proposal should help to ensure that customers are placed in the account that is the most appropriate for them.[46]

The Commission believes the proposed rule change strengthens the NYSE's ability to address the particular regulatory concerns raised by NFBA Programs.[47] The Commission further believes that the proposed rule change should help to ensure that customers receive sufficient information to make a reasonably informed determination as to whether an NFBA Program is

---

45 See, e.g., Aaron Pressman and Amy Borrus, "A Poor Fit for Investors?," Business Week, May 9, 2005, pp. 78-79; Kaja Whitehouse, "Some Investors Can Be Left Flat by Annual Fees," The Wall Street Journal, April 14, 2004, at D7; and Ruth Simon, "Fee Accounts Face Scrutiny by Regulators – SEC, Others Probe Programs that Charge Investors Fees Instead of Commissions for Trades," The Wall Street Journal, October 5, 2004, at D1.

46 For dual NYSE and NASD members the new NYSE Rule 405A will augment guidance that NASD provided in NASD NTM 03-68 (Nov. 2003) regarding fee-based compensation programs.

47 The Commission agrees with the NYSE that, given the growth of these programs, "specific, enforceable standards of compliance are warranted." See Amendment No. 2. Because the proposed rule, as amended, provides firms flexibility in implementing compliance procedures, the Commission does not believe that it will discourage firms from offering these programs.

appropriate for them.[48] Although the Commission believes that cost is likely to be the key factor in determining whether a customer should be in an NFBA Program, it also believes that it is appropriate to consider other factors as well, such as the services provided and customer objectives and preferences. This appropriateness determination is strengthened by the requirement in the proposed rule that NYSE members establish and maintain systems and procedures adequate to monitor, on an ongoing basis, transactional activity by customers in NFBA Programs.[49] In Amendment No. 2, the NYSE amended the proposed rule to provide that the systems and procedures must include only "written criteria" (rather than "specific transactional parameters or criteria"). The Commission believes that this amendment is appropriate because it clarifies that the proposed rule does not require that NYSE members generate "automated exception reports."[50]

---

[48] While the Commission believes that an annual disclosure requirement and a requirement that members determine "projected customer costs," both of which were originally proposed, could have strengthened the rule, we do believe that the amended proposal will provide investors with a degree of protection from being in placed in inappropriate accounts that is not currently available. Moreover, the Commission notes that the disclosure requirement is complemented by the additional requirement in the proposed rule that NYSE members make an appropriateness determination prior to opening an account in an NFBA Program. See proposed Rule 405A(2).

[49] See proposed Rule 405A(3).

[50] Two commenters raised this concern. See SIA Letter and Stevens Letter. The Commission notes that identifying customers whose level of account activity may be inappropriate in the context of the customer's Program does not create "a presumption that certain customers should have been in different types of accounts," as one commenter was concerned. See Stevens Letter. Rather, the Commission believes it provides, as the NYSE states, "an opportunity to determine appropriateness." See Amendment No. 2. Nevertheless, the Commission expects that the NYSE will conduct regular examinations to determine the frequency with which firms are placing customers in NFBA Programs that are inappropriate for those customers. A high percentage of initial placements in inappropriate accounts by a particular member or registered representative may suggest a need for more vigorous procedures for determining the appropriateness of account placement.

The Commission believes that the follow-up requirement in the proposed rule will ensure that members take active steps to contact customers who may be in inappropriate accounts.[51] Amendment No. 2 clarifies that NYSE members are only required to follow up with customers so long as they continue to be identified in the monitoring stage by adding the words "as appropriate" to the end of the first sentence of paragraph (4). The Commission agrees with the NYSE that a 12-month review cycle is a reasonable review period to flag customers who may be in inappropriate accounts. Because the proposed rule does not prescribe the means to follow up with customers, it should not be difficult to integrate the proposed requirements into member organizations' existing systems and procedures for follow-up customer contact.[52]

The Commission believes that the exception in the proposed rule for "Qualified Investors," as that term is defined in Section 3(a)(54) of the Exchange Act, is appropriate.[53] As the NYSE correctly notes, underlying the Qualified Investor standard is the presumption that such persons are sophisticated investors who are capable of ensuring responsible handling of funds under management.[54] Accordingly, the level of disclosure required for retail customers may not be warranted for such investors.

The Commission finds good cause for approving Amendment No. 2 and Amendment No. 3 before the thirtieth day after the date of publication of notice of filing thereof in the Federal Register. Amendment No. 2 clarifies certain aspects of the proposed rule that commenters found confusing, as well as makes minor changes to give members greater flexibility in the

51 See proposed Rule 405A(4).

52 The Commission does not agree with one commenter that it will be difficult to make effective contact with customers on an annual basis or necessitate a "tremendous use of personnel resource, unavailable to most firms." See Stevens Letter.

53 See proposed Rule 405A(5).

54 See Amendment No. 2.

administration of the proposed rule. Amendment No. 3 corrects a non-substantive typographical rule text error included in Exhibit 5 of the Amendment No. 2 filing.

VI. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether Amendment No. 2 and Amendment No. 3 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-2004-13 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-9303.

All submissions should refer to File Number SR-NYSE-2004-13. 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 Section, 100 F Street, NE, Washington, DC 20549-9303. Copies of such filing also will be available for inspection and copying at the principal office of the NYSE. 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-2004-13 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

VII. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[55] that the proposed rule change (File No. SR-NYSE-2004-13) be, and it hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[56]

J. Lynn Taylor
Assistant Secretary

---

55 15 U.S.C. 78s(b)(2).

56 17 CFR 200.30-3(a)(12).