

January 16, 2002

Katherine A. England
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1001

Re: **File No. SR-NASD-2002-11** -- Proposed Amendments to Rule 2260 to Require Broker-Dealers to Forward Communications Regarding Debt Securities to Beneficial Owners

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed please find the above-numbered rule filing. Also enclosed is a 3-1/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register release.

If you have any questions, please contact Sharon K. Zackula, Assistant General Counsel, Office of General Counsel, NASD Regulation, Inc., at (202) 728-8985; e-mail sharon.zackula@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Patrice M. Gliniecki
Vice President
and Acting General Counsel

Enclosures

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C.

Form 19b-4

Proposed Rule Change

by

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Pursuant to Rule 19b-4 under the
Securities Exchange Act of 1934

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act" or "Act"), the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly owned subsidiary, NASD Regulation, Inc. ("NASD Regulation"), is filing with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change to amend NASD Rule 2260 to require a broker-dealer to make reasonable efforts to forward a communication from an issuer or a trustee regarding a debt security to the beneficial owner of such security. The proposed rule change would also clarify IM-2260 (Suggested Rate of Reimbursement) to reflect that, in forwarding proxies and other materials, members may not charge for envelopes that are provided by the issuer or the trustee, as well as by persons soliciting proxies.

Below is the text of the proposed rule change.¹ Proposed new language is underlined and in boldface; proposed deletions are in brackets.

* * * *

2260. Forwarding of Proxy and Other Materials

(a) A member has an inherent duty [in carrying out high standards of commercial honor and just and equitable principles of trade] to forward **promptly certain information regarding a security to the beneficial owner (or the beneficial owner's designated investment adviser)**

¹ In addition to the proposed changes to Rule 2260 set forth below, in 1999 the NASD proposed to amend Rule 2260 to allow NASD members to give proxies in the absence of written instructions from beneficial owners of securities. See SR-NASD-1999-63 and Amendment No. 1 thereto, filed, respectively, on Oct. 21, 1999, and Nov. 10, 1999. Although the proposed change was published for notice and comment, SR-NASD-1999-63 remains pending before the Commission. See Securities Exchange Act Release No. 42238, 64 FR 71836 (Dec. 22, 1999) (notice of filing of proposed rule change). The rule change proposed herein is drafted based on the current text of Rule 2260, rather than on the amendments proposed in SR-NASD-1999-63. If necessary, the NASD will amend SR-NASD-1999-63 to conform the rule text therein to the rule text proposed in this rule filing.

if the member carries the account in which the security is held for the beneficial owner and the security is registered in a name other than the name of the beneficial owner.

(1) Equity Securities

For an equity security, the member must forward:

(A)[(1)]all proxy material [which] **that** is properly furnished to **the member** [it] by the issuer of the securities or a stockholder of such issuer; [to each beneficial owner of shares of that issue (or the beneficial owner's designated investment adviser) which are held by the member for the beneficial owner thereof] and

(B)[(2)]all annual reports, information statements and other materials sent to stockholders[, which] **that** are properly furnished to **the member**[it] by the issuer of the securities. [to each beneficial owner of shares of that issue (or the beneficial owner's designated investment adviser) which are held by the member for the beneficial owner thereof.]

(2) Debt Securities

For a debt security other than a municipal security, the member must make reasonable efforts to forward any communication, document, or collection of documents pertaining to the issue that: (A) was prepared by or on behalf of, the issuer, or was prepared by or on behalf of, the trustee of the specific issue of the security; and (B) contains material information about such issue including, but not limited to, notices concerning monetary or technical defaults, financial reports, information statements, and material event notices.

(b) No member shall give a proxy to vote stock [which] that is registered in its name, except as required or permitted under the provisions of paragraphs (c) or (d) hereof, unless such member is the beneficial owner of such stock.

(c) (1) No change.

(A) sufficient copies of all soliciting material [which] that such person is sending to registered holders, and

(B) satisfactory assurance that he or she will reimburse such member for all out-of-pocket expenses, including reasonable clerical expenses incurred by such member in connection with such solicitation,

such member shall transmit promptly to each beneficial owner of stock of such issuer (or the beneficial owner's designated investment adviser) [which] that is in its possession or control and registered in a name other than the name of the beneficial owner, all such material furnished.

Such material shall include a signed proxy indicating the number of shares held for such beneficial owner and bearing a symbol identifying the proxy with proxy records maintained by the member, and a letter informing the beneficial owner (or the beneficial owner's designated investment adviser) of the time limit and necessity for completing the proxy form and forwarding it to the person soliciting proxies prior to the expiration of the time limit in order for the shares to be represented at the meeting. A member shall furnish a copy of the symbols to the person soliciting the proxies and shall also retain a copy thereof pursuant to the provisions of SEC Rule 17a-4 [under the Act].

(c) (2) through (3) No change.

(d) (1) No change.

(2) A member [which] **that** has in its possession or within its control stock registered in the name of another member and [which] **that** desires to transmit signed proxies pursuant to the provisions of paragraph (c), shall obtain the requisite number of signed proxies from such holder of record.

(3) No change.

(A) No change.

(B) any **designated investment adviser** [person registered as an investment adviser under the Investment Advisers Act of 1940 who exercises investment discretion pursuant to an advisory contract for the beneficial owner to vote the proxies for stock which is in the possession or control of the member,] may vote such proxies.

(e) (1) **As required in paragraph (a), a** [A] member [when so requested by an issuer and upon being furnished with:] **must forward promptly the material set forth in (a)(1), in connection with an equity security, or must make reasonable efforts to forward promptly the material set forth in (a)(2), in connection with a debt security, provided that the member:**

(A) **is furnished with** sufficient copies of [annual reports, information statements or other material sent to stockholders, and] **the material (e.g., annual reports, information statements or other material sent to security holders) by the issuer, stockholder, or trustee;**

(B) is requested by the issuer, stockholder, or trustee to forward the material to security holders; and,

(C) receives [(B)]satisfactory assurance that it will be reimbursed by such issuer, **stockholder, or trustee** for all out-of-pocket expenses, including reasonable clerical expenses[.].

[shall transmit promptly to each beneficial owner of stock of such issuer (or the beneficial owner's designated investment adviser) which is in its possession and control and registered in a name other than the name of the beneficial owner of all such material furnished.]

(2) No change.

(f) For purposes of this Rule, the term "designated investment adviser" is a person registered under the Investment Advisers Act of 1940 who exercises investment discretion pursuant to an advisory contract for the beneficial owner and is designated in writing by the beneficial owner to receive proxy and related materials and vote the proxy, and to receive annual reports and other material sent to [stockholders] **security holders**.

(1) No change.

(2) Members [who] **that** receive such a written designation from a beneficial owner must ensure that the designated investment adviser is registered with the Commission pursuant to the Investment Advisers Act [or] **of** 1940 and that the investment adviser is exercising investment discretion over the customer's account pursuant to an advisory contract to vote proxies and/or to receive proxy soliciting material, annual reports and other material. Members must keep records substantiating this information.

(3) No change.

(g) No change.

* For purposes of this Rule, the term “ERISA” is an acronym for the Employee Retirement Income Security Act of 1974.

IM-2260. Suggested Rates of Reimbursement

(a) No change.

(1) Charges for Initial Proxy and/or Annual Report Mailings

(A) No change.

(B) 20 cents for each copy, plus postage, for annual reports[, which] **that** are mailed separately from the proxy material pursuant to the instruction of the person soliciting proxies.

(2) No Change.

(3) No Change.

(4) No Change.

(5) No Change.

(b) Members may charge for envelopes, provided that they are not furnished by **the issuer, the trustee, or a** [the] person soliciting proxies.

(c) No change.

* * * *

(b) Not applicable.

(c) Not applicable.

2. **Procedures of the Self-Regulatory Organization**

(a) The proposed rule change was approved by the Board of Directors of NASD Regulation at its meeting on December 5, 2001, which authorized the filing of the rule change

with the SEC. Counsel for The Nasdaq Stock Market and NASD Dispute Resolution have been provided an opportunity to consult with respect to the proposed rule change pursuant to the Plan of Allocation and Delegation of Functions by the NASD to its Subsidiaries. The NASD Board of Governors had an opportunity to review the proposed rule change at its meeting on December 6, 2001. No other action by the NASD is necessary for the filing of the proposed rule change. Section 1(a)(ii) of Article VII of the NASD By-Laws permits the NASD Board of Governors to adopt amendments to NASD Rules without recourse to the membership for approval.

The NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The effective date will be 30 days following publication of the Notice to Members announcing Commission approval.

(b) Questions regarding this rule filing may be directed to Sharon K. Zackula, Assistant General Counsel, NASD Regulation, Office of General Counsel, at (202) 728-8985.

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

(a) Purpose

Introduction

Rule 2260 currently provides that a member has an inherent duty in carrying out high standards of commercial honor and just and equitable principles of trade to forward certain information regarding a security to the beneficial owner of such security (or the beneficial owner's designated investment advisor) if the security is held by the member for the beneficial owner, is in the member's possession and control, and is registered in a name other than the name of the beneficial owner.

As currently drafted, however, Rule 2260 does not impose an obligation on members to forward information relating to debt securities to the beneficial owners of such securities. For instance, the communications covered by the Rule are limited to proxy material, all annual reports, information statements, and "other material sent to stockholders (emphasis added)." The Rule also limits the member's obligation to forward proxy material to each beneficial owner of shares of that issue (or the beneficial owner's designated investment adviser) for shares that are held by the member for the beneficial owner. NASD Regulation believes that the lack of any affirmative requirement on broker-dealers to forward information to customers who are beneficial owners of debt securities raises customer protection issues.

Background

When the securities industry, with the cooperation of the SEC, began to urge owners to hold securities in "street name," the transition from paper certificates to electronic record of ownership was to be accomplished by providing the beneficial owners of securities held in street name with the same rights and privileges as an owner holding paper certificates. Using the Depository Trust and Clearing Corporation's ("DTCC") book-entry system for establishing ownership results in a chain of records that documents securities ownership, but positions as many as three or four "nominee" owners above the beneficial owner. Through this chain, certain communications from issuers, trustees, and others regarding securities, whether or not covered explicitly by NASD Rule 2260 or parallel exchange rules,² are passed through from nominee to nominee until the communication reaches the broker-dealer that holds the securities in street name for its customers.

² See, e.g., New York Stock Exchange Rule 451 ("Transmission of Proxy Material").

The current chain of communication was developed informally over a number of years through the efforts of the SEC, the Municipal Securities Rulemaking Board (“MSRB”), other federal and state regulators, and various industry groups, such as The Bond Market Association (“TBMA”) (formerly, the Public Securities Association). In May 1998, a working group published certain “best practices” regarding communications from issuers to beneficial owners of defaulted municipal securities.³ Because industry compliance with the best practices is voluntary, NASD Regulation determined to recommend rule amendments to address this issue.

Proposed Amendments to NASD Rule 2260

NASD Regulation believes that the customer protection issues arising from the lack of any affirmative requirement on broker-dealers to forward information to customers who are beneficial owners of debt securities should be remedied. To address the regulatory gap, NASD Regulation has developed amendments to Rule 2260 to extend its obligations to debt securities.

The proposed amendments would make Rule 2260 applicable to debt securities but do not otherwise materially change the basic principles and assumptions of the Rule. The proposed amendment would require members to forward information they receive that is “prepared by or on behalf of” the issuer of the security or the trustee and that contains information about such issue including, but not limited to, notices concerning monetary or technical defaults, financial reports, information statements, and material event notices. However, as is currently the case with equity securities, a member’s obligation to forward the material does not arise unless the member “receives satisfactory assurance” that it will be reimbursed by such issuer or trustee for

³ See Joint Recommendations for Communicating with the Beneficial Owners of Defaulted Municipal Securities.

all out-of pocket expenses, is furnished with the material by the issuer or the trustee, and is requested by the issuer or the trustee to forward the material.⁴

The proposed amendment includes language that, as applied to equity securities communications and documentation, is meant to clarify the Rule's existing obligations, not to change them. The proposed change provides: "A member has an inherent duty to forward promptly certain information regarding a security to the beneficial owner (or the beneficial owner's designated investment adviser) if the member carries the account in which the security is held for the beneficial owner and the security is registered in a name other than the name of the beneficial owner (emphasis added)." The change was made in response to concerns that the current Rule 2260 does not identify clearly which members are responsible for forwarding information to the beneficial holders of securities. The amendments intend to make clear that those firms that carry customer accounts and are capable of identifying the beneficial holders of the accounts are responsible for the member obligations in Rule 2260. As a result, the responsibility to forward information generally will fall on the clearing firm, provided the clearing firm is aware of the identity of the beneficial owners of the accounts. In those cases where a clearing firm is not aware of the identity of the beneficial owners of the accounts, such as when another firm opens an omnibus account with the clearing firm, the firm that opens the omnibus account will be the "carrying firm" for purposes of the Rule, and therefore will be responsible for forwarding the information.

⁴ These conditions in Rule 2260 relating to equity securities are similar to those found in NYSE Rules (*e.g.*, 451 and 465), providing for the forwarding of proxy and other materials.

NASD Regulation also is proposing an amendment to IM-2260 to clarify that, in forwarding proxies and other materials, members may not charge for envelopes that are provided by the issuer or the trustee, as well as by persons soliciting proxies.

(b) Statutory Basis

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The proposed rule change is designed to provide customer protection for all holders of debt securities by establishing an affirmative obligation on broker-dealers to forward certain information regarding those securities to the beneficial owners.

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

NASD Regulation does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

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

Written comments from members were neither solicited nor received.

6. Extension of Time Period for Commission Action

NASD Regulation does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Exhibits

1. Exhibit 1.

Pursuant to the requirements of the Securities Exchange Act of 1934, NASD Regulation has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

NASD REGULATION, INC.

BY: _____
Patrice M. Gliniecki, Vice President and Acting General Counsel

Date: January 16, 2002

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34- [leave space] ; File No. SR-NASD-2002-11)

[leave space for date]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Amendments to NASD Rule 2260 To Require the Forwarding of Issuer and Trustee Communications to Beneficial Holders of Debt Securities

(a) Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act” or “Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on [leave space], the National Association of Securities Dealers, Inc. (“NASD” or “Association”), through its wholly owned subsidiary, NASD Regulation, Inc. (“NASD Regulation”), filed with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to amend Rule 2260 to require a member to make reasonable efforts to forward a communications from an issuer or a trustee regarding a debt security to the beneficial owner of such security. The proposed rule change would also clarify IM-2260 (Suggested Rate of Reimbursement) regarding certain member charges. The proposed rule change is described in Items I, II, and III below, which Items have been prepared by NASD Regulation.

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE

NASD Regulation is proposing to amend Rule 2260 of the rules of the National Association of Securities Dealers, Inc. (“NASD” or “Association”), to require a broker-dealer to make reasonable efforts to forward a communication from an issuer or a trustee regarding a debt security to the beneficial owner of such security. The proposed rule change would also clarify

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

IM-2260 (Suggested Rate of Reimbursement) to reflect that, in forwarding proxies and other materials, members may not charge for envelopes that are provided by the issuer or the trustee, as well as by persons soliciting proxies.

Below is the text of the proposed rule change.³ Proposed new language is in italics; proposed deletions are in brackets.

* * * *

2260. Forwarding of Proxy and Other Materials

(a) A member has an inherent duty [in carrying out high standards of commercial honor and just and equitable principles of trade] to forward **promptly certain information regarding a security to the beneficial owner (or the beneficial owner's designated investment adviser) if the member carries the account in which the security is held for the beneficial owner and the security is registered in a name other than the name of the beneficial owner.**

(1) Equity Securities

For an equity security, the member must forward:

(A)[(1)]all proxy material [which] **that** is properly furnished to **the member** [it] by the issuer of the securities or a stockholder of such issuer;[,to each beneficial owner of shares of that issue (or the beneficial owner's designated investment adviser) which are held by the member for the beneficial owner thereof] and

³ In addition to the proposed changes to Rule 2260 set forth below, in 1999 the NASD proposed to amend Rule 2260 to allow NASD members to give proxies in the absence of written instructions from beneficial owners of securities. See SR-NASD-1999-63 and Amendment No. 1 thereto, filed, respectively, on Oct. 21, 1999, and Nov. 10, 1999. Although the proposed change was published for notice and comment, SR-NASD-1999-63 remains pending before the Commission. See Securities Exchange Act Release No. 42238, 64 FR 71836 (Dec. 22, 1999) (notice of filing of proposed rule change). The rule change proposed herein is drafted based on the current text of

(B)[(2)]all annual reports, information statements and other materials sent to stockholders[, which] **that** are properly furnished to **the member**[it] by the issuer of the securities. [to each beneficial owner of shares of that issue (or the beneficial owner's designated investment adviser) which are held by the member for the beneficial owner thereof.]

(2) Debt Securities

For a debt security other than a municipal security, the member must make reasonable efforts to forward any communication, document, or collection of documents pertaining to the issue that: (A) was prepared by or on behalf of, the issuer, or was prepared by or on behalf of, the trustee of the specific issue of the security; and (B) contains material information about such issue including, but not limited to, notices concerning monetary or technical defaults, financial reports, information statements, and material event notices.

(a) No member shall give a proxy to vote stock [which] **that** is registered in its name, except as required or permitted under the provisions of paragraphs (c) or (d) hereof, unless such member is the beneficial owner of such stock.

(b) No Change.

(c) (1) No change.

(A) sufficient copies of all soliciting material [which] **that** such person is sending to registered holders, and

(B) satisfactory assurance that he **or she** will reimburse such member for all out-of-pocket expenses, including reasonable clerical expenses incurred by such member in connection with such solicitation,

such member shall transmit promptly to each beneficial owner of stock of such issuer (or the beneficial owner's designated investment adviser) [which] **that** is in its possession or control and registered in a name other than the name of the beneficial owner, all such material furnished.

Such material shall include a signed proxy indicating the number of shares held for such beneficial owner and bearing a symbol identifying the proxy with proxy records maintained by the member, and a letter informing the beneficial owner (or the beneficial owner's designated investment adviser) of the time limit and necessity for completing the proxy form and forwarding it to the person soliciting proxies prior to the expiration of the time limit in order for the shares to be represented at the meeting. A member shall furnish a copy of the symbols to the person soliciting the proxies and shall also retain a copy thereof pursuant to the provisions of SEC Rule 17a-4 [under the Act].

(2) through (3)

(d) (1) No change.

(2) A member [which] **that** has in its possession or within its control stock registered in the name of another member and [which] **that** desires to transmit signed proxies pursuant to the provisions of paragraph (c), shall obtain the requisite number of signed proxies from such holder of record.

(3) No change.

(A) No change.

(B) any **designated investment adviser** [person registered as an investment adviser under the Investment Advisers Act of 1940 who exercises investment discretion pursuant to an advisory contract for the beneficial owner to vote the proxies for stock which is in the possession or control of the member,] may vote such proxies.

(e) (1) **As required in paragraph (a), a** [A] member [when so requested by an issuer and upon being furnished with:] **must forward promptly the material set forth in (a)(1), in connection with an equity security, or must make reasonable efforts to forward promptly the material set forth in (a)(2), in connection with a debt security, provided that the member:**

(A) **is furnished with** sufficient copies of [annual reports, information statements or other material sent to stockholders, and] **the material (e.g., annual reports, information statements or other material sent to security holders) by the issuer, stockholder, or trustee;**

(B) is requested by the issuer, stockholder, or trustee to forward the material to security holders; and,

(C) receives [(B)] satisfactory assurance that it will be reimbursed by such issuer, **stockholder, or trustee** for all out-of-pocket expenses, including reasonable clerical expenses[,],

[shall transmit promptly to each beneficial owner of stock of such issuer (or the beneficial owner's designated investment adviser) which is in its possession and control and

registered in a name other than the name of the beneficial owner of all such material furnished.]

(2) No change.

(f) For purposes of this Rule, the term “designated investment adviser” is a person registered under the Investment Advisers Act of 1940 who exercises investment discretion pursuant to an advisory contract for the beneficial owner and is designated in writing by the beneficial owner to receive proxy and related materials and vote the proxy, and to receive annual reports and other material sent to [stockholders] **security holders**.

(1) No change.

(2) Members [who] **that** receive such a written designation from a beneficial owner must ensure that the designated investment adviser is registered with the Commission pursuant to the Investment Advisers Act [or] **of** 1940 and that the investment adviser is exercising investment discretion over the customer’s account pursuant to an advisory contract to vote proxies and/or to receive proxy soliciting material, annual reports and other material. Members must keep records substantiating this information.

(3) No change.

(g) No change.

* For purposes of this Rule, the term “ERISA” is an acronym for the Employee Retirement Income Security Act of 1974.

IM-2260. Suggested Rates of Reimbursement

(a) No change.

(1) Charges for Initial Proxy and/or Annual Report Mailings

(A) No change.

(B) 20 cents for each copy, plus postage, for annual reports[, which] that are mailed separately from the proxy material pursuant to the instruction of the person soliciting proxies.

(2) No Change.

(3) No Change.

(4) No Change.

(5) No Change.

(b) Members may charge for envelopes, provided that they are not furnished by the issuer, the trustee, or a [the] person soliciting proxies.

(c) No change.

* * * *

II. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE

In its filing with the Commission, NASD Regulation 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. NASD Regulation 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

(a) Purpose

Introduction

Rule 2260 currently provides that a member has an inherent duty in carrying out high standards of commercial honor and just and equitable principles of trade to forward certain information regarding a security to the beneficial owner of such security (or the beneficial owner's designated investment advisor) if the security is held by the member for the beneficial owner, is in the member's possession and control, and is registered in a name other than the name of the beneficial owner.

As currently drafted, however, Rule 2260 does not impose an obligation on members to forward information relating to debt securities to the beneficial owners of such securities. For instance, the communications covered by the Rule are limited to proxy material, all annual reports, information statements, and "other material sent to stockholders (emphasis added)." The Rule also limits the member's obligation to forward proxy material to each beneficial owner of shares of that issue (or the beneficial owner's designated investment advisor) for shares that are held by the member for the beneficial owner. NASD Regulation believes that the lack of any affirmative requirement on broker-dealers to forward information to customers who are beneficial owners of debt securities raises customer protection issues.

Background

When the securities industry, with the cooperation of the SEC, began to urge owners to hold securities in "street name," the transition from paper certificates to electronic record of

ownership was to be accomplished by providing the beneficial owners of securities held in street name with the same rights and privileges as an owner holding paper certificates. Using the Depository Trust and Clearing Corporation's ("DTCC") book-entry system for establishing ownership results in a chain of records that documents securities ownership, but positions as many as three or four "nominee" owners above the beneficial owner. Through this chain, certain communications from issuers, trustees, and others regarding securities, whether or not covered explicitly by NASD Rule 2260 or parallel exchange rules,⁴ are passed through from nominee to nominee until the communication reaches the broker-dealer that holds the securities in street name for its customers.

The current chain of communication was developed informally over a number of years through the efforts of the SEC, the Municipal Securities Rulemaking Board ("MSRB"), other federal and state regulators, and various industry groups, such as The Bond Market Association ("TBMA") (formerly, the Public Securities Association). In May 1998, a working group published certain "best practices" regarding communications from issuers to beneficial owners of defaulted municipal securities.⁵ Industry compliance with the best practices, however, is voluntary. NASD Regulation determined to recommend rule amendments to address this issue.

Proposed Amendments to NASD Rule 2260

NASD Regulation believes that the customer protection issues arising from the lack of any affirmative requirement on broker-dealers to forward information to customers who are

⁴ See, e.g., New York Stock Exchange Rule 451 ("Transmission of Proxy Material").

⁵ See Joint Recommendations for Communicating with the Beneficial Owners of Defaulted Municipal Securities.

beneficial owners of debt securities should be remedied. To address the regulatory gap, NASD Regulation has developed amendments to Rule 2260 to extend its obligations to debt securities.

The proposed amendments would make Rule 2260 applicable to debt securities but do not otherwise materially change the basic principles and assumptions of the Rule. The proposed amendment would require members to forward information they receive that is “prepared by or on behalf of” the issuer of the security or the trustee and that contains information about such issue including, but not limited to, notices concerning monetary or technical defaults, financial reports, information statements, and material event notices. However, as is currently the case with equity securities, a member’s obligation to forward the material does not arise unless the member “receives satisfactory assurance” that it will be reimbursed by such issuer or trustee for all out-of-pocket expenses, is furnished with the material by the issuer or the trustee, and is requested by the issuer or the trustee to forward the material.⁶

The proposed amendment includes language that, as applied to equity securities communications and documentation, is meant to clarify the Rule’s existing obligations, not to change them. The proposed change provides: “A member has an inherent duty to forward promptly certain information regarding a security to the beneficial owner (or the beneficial owner’s designated investment adviser) if the member carries the account in which the security is held for the beneficial owner and the security is registered in a name other than the name of the beneficial owner (emphasis added).” The change was made in response to concerns that the current Rule 2260 does not identify clearly which members are responsible for forwarding information to the beneficial holders of securities. The amendments intend to make clear that

⁶ These conditions in Rule 2260 relating to equity securities are similar to those found in NYSE Rules (*e.g.*, 451 and 465), providing for the forwarding of proxy and other materials.

those firms that carry customer accounts and are capable of identifying the beneficial holders of the accounts are responsible for the member obligations in Rule 2260. As a result, the responsibility to forward information generally will fall on the clearing firm, provided the clearing firm is aware of the identity of the beneficial owners of the accounts. In those cases where a clearing firm is not aware of the identity of the beneficial owners of the accounts, such as when another firm opens an omnibus account with the clearing firm, the firm that opens the omnibus account will be the “carrying firm” for purposes of the Rule, and therefore will be responsible for forwarding the information.

NASD Regulation also is proposing an amendment to IM-2260 to clarify that, in forwarding proxies and other materials, members may not charge for envelopes that are provided by the issuer or the trustee, as well as by persons soliciting proxies.

(b) Statutory Basis

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association’s rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The proposed rule change is designed to provide customer protection for all holders of debt securities by establishing an affirmative obligation on broker-dealers to forward certain information regarding those securities to the beneficial owners.

(B) Self-Regulatory Organization's Statement on Burden on Competition

NASD Regulation does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

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

Written 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 self-regulatory organization consents, the Commission will:

- A. by order approve such proposed rule change, or
- B. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. 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 will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17 CFR 200.30-3(a)(12).

Jonathan G. Katz
Secretary