

February 10, 2004

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-2004-027; Proposed Amendment to Rule Relating to Execution of Investment Company Portfolio Transactions

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 Thomas M. Selman, Office of Investment Company Regulation, NASD, at (202) 728-6977, e-mail tom.selman@nasd.com or Philip Shaikun, Office of General Counsel, Regulatory Policy and Oversight, NASD, at (202) 728-8451, e-mail philip.shaikun@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Barbara Z. Sweeney
Senior Vice President
and Corporate Secretary

Enclosures

File No. SR-NASD-2004-027
Consists of 18 Pages
February 10, 2004

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 (“Act”), the National Association of Securities Dealers, Inc. (“NASD”) is filing with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to amend NASD Rule 2830(k). Rule 2830(k) generally prohibits members from favoring the sale of shares of any mutual fund on the basis of brokerage commissions received or expected by the member from any source, including the fund. The rule permits a member to sell a mutual fund that considers the sale of its shares as a factor in the selection of broker/dealers to execute its brokerage transactions. NASD proposes to eliminate this exception and prohibit members from selling any mutual fund if the member knows or has reason to know that the fund or certain of its affiliates have entered into an agreement or understanding to direct fund portfolio securities transactions in exchange for the promotion or sale of fund shares. Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

* * * * *

2830. Investment Company Securities

(a) through (j) No change.

(k) Execution of Investment Company Portfolio Transactions

(1) No member shall, directly or indirectly, favor or disfavor the sale or distribution of shares of any particular investment company or group of investment companies on the basis of brokerage commissions received or expected by such member from any source, including such investment company, or any covered account.

(2) No member shall sell shares of, or act as underwriter for, an investment company, if the member knows or has reason to know that such investment company, or an investment adviser or principal underwriter of the company, has entered into a written or oral agreement or understanding under which the company is expected to direct portfolio securities transactions (or any commission, markup or other remuneration resulting from any such transaction) to a broker or a dealer in consideration for the promotion or sale of shares issued by the company.

[(2)] (3) No member shall, directly or indirectly, demand or require brokerage commissions or solicit a promise of such commissions from any source as a condition to the sale or distribution of shares of an investment company.

[(3)] (4) No member shall, directly or indirectly, offer or promise to another member, brokerage commissions from any source as a condition to the sale or distribution of shares of an investment company and no member shall request or arrange for the direction to any member of a specific amount or percentage of brokerage commissions conditioned upon that member's sales or promise of sales of shares of an investment company.

[(4)] (5) No member shall circulate any information regarding the amount or level of brokerage commissions received by the member from any investment company or covered account to other than management personnel who are required, in the overall management of the member's business, to have access to such information.

[(5)] (6) No member shall, with respect to such member's activities as underwriter of investment company shares, suggest, encourage, or sponsor any incentive campaign or special sales effort of another member with respect to the shares of any investment company which incentive or sales effort is, to the knowledge or understanding of such underwriter-member, to be based upon, or financed by, brokerage commissions directed or arranged by the underwriter-member.

[(6)] (7) No member shall, with respect to such member's retail sales or distribution of investment company shares:

(A) provide to salesmen, branch managers or other sales personnel any incentive or additional compensation for the sale of shares of specific investment companies based on the amount of brokerage commissions received or expected from any source, including such investment companies or any covered account. Included in this prohibition are bonuses, preferred compensation lists, sales incentive campaign or contests, or any other method of compensation which provides an incentive to sales personnel to favor or disfavor any investment company or group of investment companies based on brokerage commissions;

(B) recommend specific investment companies to sales personnel, or establish "recommended," "selected," or "preferred" lists of investment companies, regardless of the existence of any special compensation or incentives to favor or disfavor the shares of such company or companies in

sales efforts, if such companies are recommended or selected on the basis of brokerage commissions received or expected from any source;

(C) grant to salesmen, branch managers or other sales personnel any participation in brokerage commissions received by such member from portfolio transactions of an investment company whose shares are sold by such member, or from any covered account, if such commissions are directed by, or identified with, such investment company or any covered account; or

(D) use sales of shares of any investment company as a factor in negotiating the price of, or the amount of brokerage commissions to be paid on, a portfolio transaction of an investment company or of any covered account, whether such transaction is executed in the over-the-counter market or elsewhere.

[(7)] (8) Provided that the member does not violate any of the specific provisions of this paragraph (k), nothing herein shall be deemed to prohibit:

(A) the execution of portfolio transactions of any investment company or covered account by members who also sell shares of the investment company;

[(B) a member from selling shares of, or acting as underwriter for, an investment company which follows a policy, disclosed in its prospectus, of considering sales of shares of the investment company as a factor in the selection of broker/dealers to execute portfolio transactions, subject to the requirements of best execution;]

[(B)] (C) a member from compensating its salesmen and managers based on total sales of investment company shares attributable to such salesmen or managers, whether by use of overrides, accounting credits, or other compensation methods, provided that such compensation is not designed to favor or disfavor sales of shares of particular investment companies on a basis prohibited by this paragraph (k).

(l) through (n) No change.

* * * * *

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

(a) The proposed rule change and the filing of the rule change with the SEC was approved by the Board of Directors of NASD Regulation, Inc. by unanimous written consent on February 4, 2004. 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 NASD to its Subsidiaries. The NASD Board of Governors had an opportunity to review the proposed rule change by action of February 5, 2004. No other action by 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.

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 no less than 30 days following publication of the Notice to Members announcing Commission approval.

(b) Questions regarding this rule filing may be directed to Philip Shaikun, Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, NASD at (202) 728-8451.

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

(a) Purpose

Rule 2830(k) governs members' execution of investment company portfolio transactions. The rule generally prohibits members from favoring the sale of shares of any investment company on the basis of brokerage commissions received or expected by the member from any source, including the fund. The rule is designed to prevent *quid pro quo* arrangements in which brokerage commissions, which represent an asset of the fund, are used to compensate members for selling fund shares. The rule includes an exception that permits a member to sell the shares of, or act as an underwriter for, an investment company that follows a policy, disclosed in its prospectus, of considering sales of shares of the investment company as a factor in the selection of broker/dealers to execute fund portfolio transactions, subject to the requirements of best execution. NASD proposes to eliminate this exception due to concerns that the exception undermines the purpose of the rule

The proposed rule change also includes language to clarify that no member may sell the shares of or act as underwriter for, an investment company if the member knows, or has reason to know, that such investment company, or an investment adviser or principal underwriter of the company, has entered into a written or oral agreement or understanding under which the company

is expected to direct portfolio securities transactions (or any commission, markup or other enumeration resulting from any such transaction) to a broker or a dealer in consideration for the promotion or sale of shares issued by the company. Under the proposed rule change, a member would not violate Rule 2830(k) solely because the member promotes or sells the shares of an investment company that directs fund portfolio transactions to the member, unless the member knows or has reason to know that the fund has entered into agreements or understandings to direct fund brokerage in exchange for distribution.

Recent events in the investment company industry have heightened NASD's concern that fund brokerage may be used to inappropriately encourage members to promote or sell the shares of particular funds. The proposed rule change will strengthen Rule 2830(k)'s prohibitions in this regard.

(b) Statutory Basis

NASD 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 NASD 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. One important purpose of Rule 2830(k) is to help eliminate conflicts of interest in the sale of investment company securities, and the proposed rule change will improve NASD's ability to achieve this objective.

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

NASD 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 were neither solicited nor received.

6. Extension of Time Period for Commission Action

NASD 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

On February 11, the SEC will consider whether to propose amendments to SEC Rule 12b-1 to provide that an investment company may not compensate a broker or dealer for any promotion or sale of shares issued by that company by, among other things, directing the company's portfolio securities transactions to the broker or dealer. The proposed rule change is intended to amend Rule 2830(k) to place a comparable prohibition on members not to promote or sell the shares of investment companies that have agreements or understandings to direct fund portfolio transactions to compensate for the sale or promotion of the company's securities. The proposed rule change also eliminates a provision that specifically permits members to sell or act as underwriter of funds that consider sales of fund shares as a factor in selecting broker/dealers to execute portfolio transactions.

9. Exhibits

1. Completed notice of proposed rule change for publication in the Federal Register.

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

NASD

BY: _____
Barbara Z. Sweeney, Senior Vice President and
Corporate Secretary

Date: February 10, 2004

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- []; File No. SR-NASD-2004-027)
[]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Investment Company Portfolio Transactions

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 February 10, 2004, the National Association of Securities Dealers, Inc. (“NASD”), 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 NASD. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

NASD is proposing to amend NASD Conduct Rule 2830(k). Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

* * * * *

2830. Investment Company Securities

(a) through (j) No change.

(k) Execution of Investment Company Portfolio Transactions

(1) No member shall, directly or indirectly, favor or disfavor the sale or distribution of shares of any particular investment company or group of

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

investment companies on the basis of brokerage commissions received or expected by such member from any source, including such investment company, or any covered account.

(2) No member shall sell shares of, or act as underwriter for, an investment company, if the member knows or has reason to know that such investment company, or an investment adviser or principal underwriter of the company, has entered into a written or oral agreement or understanding under which the company is expected to direct portfolio securities transactions (or any commission, markup or other remuneration resulting from any such transaction) to a broker or a dealer in consideration for the promotion or sale of shares issued by the company.

[(2)] (3) No member shall, directly or indirectly, demand or require brokerage commissions or solicit a promise of such commissions from any source as a condition to the sale or distribution of shares of an investment company.

[(3)] (4) No member shall, directly or indirectly, offer or promise to another member, brokerage commissions from any source as a condition to the sale or distribution of shares of an investment company and no member shall request or arrange for the direction to any member of a specific amount or percentage of brokerage commissions conditioned upon that member's sales or promise of sales of shares of an investment company.

[(4)] (5) No member shall circulate any information regarding the amount or level of brokerage commissions received by the member from any investment company or covered account to other than management personnel who are

required, in the overall management of the member's business, to have access to such information.

[(5)] (6) No member shall, with respect to such member's activities as underwriter of investment company shares, suggest, encourage, or sponsor any incentive campaign or special sales effort of another member with respect to the shares of any investment company which incentive or sales effort is, to the knowledge or understanding of such underwriter-member, to be based upon, or financed by, brokerage commissions directed or arranged by the underwriter-member.

[(6)] (7) No member shall, with respect to such member's retail sales or distribution of investment company shares:

(A) provide to salesmen, branch managers or other sales personnel any incentive or additional compensation for the sale of shares of specific investment companies based on the amount of brokerage commissions received or expected from any source, including such investment companies or any covered account. Included in this prohibition are bonuses, preferred compensation lists, sales incentive campaign or contests, or any other method of compensation which provides an incentive to sales personnel to favor or disfavor any investment company or group of investment companies based on brokerage commissions;

(B) recommend specific investment companies to sales personnel, or establish "recommended," "selected," or "preferred" lists of investment companies, regardless of the existence of any special compensation or

incentives to favor or disfavor the shares of such company or companies in sales efforts, if such companies are recommended or selected on the basis of brokerage commissions received or expected from any source;

(C) grant to salesmen, branch managers or other sales personnel any participation in brokerage commissions received by such member from portfolio transactions of an investment company whose shares are sold by such member, or from any covered account, if such commissions are directed by, or identified with, such investment company or any covered account; or

(D) use sales of shares of any investment company as a factor in negotiating the price of, or the amount of brokerage commissions to be paid on, a portfolio transaction of an investment company or of any covered account, whether such transaction is executed in the over-the-counter market or elsewhere.

[(7)] (8) Provided that the member does not violate any of the specific provisions of this paragraph (k), nothing herein shall be deemed to prohibit:

(A) the execution of portfolio transactions of any investment company or covered account by members who also sell shares of the investment company;

[(B) a member from selling shares of, or acting as underwriter for, an investment company which follows a policy, disclosed in its prospectus, of considering sales of shares of the investment company as a factor in the

selection of broker/dealers to execute portfolio transactions, subject to the requirements of best execution;]

[(B)] (C) a member from compensating its salesmen and managers based on total sales of investment company shares attributable to such salesmen or managers, whether by use of overrides, accounting credits, or other compensation methods, provided that such compensation is not designed to favor or disfavor sales of shares of particular investment companies on a basis prohibited by this paragraph (k).

(l) through (n) No change.

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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 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. Sections (A), (B), and (C) below set forth 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

Rule 2830(k) governs members' execution of investment company portfolio transactions. The rule generally prohibits members from favoring the sale of shares of any investment company on the basis of brokerage commissions received or expected by the member from any source, including the fund. The rule is designed to prevent *quid pro quo* arrangements in which brokerage commissions, which represent an asset of the fund, are used to compensate members

for selling fund shares. The rule includes an exception that permits a member to sell the shares of, or act as an underwriter for, an investment company that follows a policy, disclosed in its prospectus, of considering sales of shares of the investment company as a factor in the selection of broker/dealers to execute fund portfolio transactions, subject to the requirements of best execution. NASD proposes to eliminate this exception due to concerns that the exception undermines the purpose of the rule

The proposed rule change also includes language to clarify that no member may sell the shares of or act as underwriter for, an investment company if the member knows, or has reason to know, that such investment company, or an investment adviser or principal underwriter of the company, has entered into a written or oral agreement or understanding under which the company is expected to direct portfolio securities transactions (or any commission, markup or other enumeration resulting from any such transaction) to a broker or a dealer in consideration for the promotion or sale of shares issued by the company. Under the proposed rule change, a member would not violate Rule 2830(k) solely because the member promotes or sells the shares of an investment company that directs fund portfolio transactions to the member, unless the member knows or has reason to know that the fund has entered into agreements or understandings to direct fund brokerage in exchange for distribution.

Recent events in the investment company industry have heightened NASD's concern that fund brokerage may be used to inappropriately encourage members to promote or sell the shares of particular funds. The proposed rule change will strengthen Rule 2830(k)'s prohibitions in this regard.

(b) Statutory Basis

NASD 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 NASD 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. One important purpose of Rule 2830(k) is to help eliminate conflicts of interest in the sale of investment company securities, and the proposed rule change will improve NASD's ability to achieve this objective.

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

NASD 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, including whether the proposed rule change [as amended] is consistent with the act. 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. Comments may also be submitted electronically at the following e-mail address: rule-comments@sec.gov. All comment letters should refer to File No. SR-NASD-2004-027. This file number should be included on the subject line if e-mail is used. To help us process and review comments more efficiently, comments should be sent in hardcopy or by e-mail but not by both methods. 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 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).

Margaret H. McFarland
Deputy Secretary