

December 17, 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-2002-180**
Proposed Rule Change Regarding Prohibition Against Guarantees and Sharing in Customer Accounts

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 Afshin Atabaki, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8902; e-mail afshin.atabaki@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

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”),¹ the National Association of Securities Dealers, Inc. (“NASD”) is filing with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to NASD Rule 2330(e) to clarify that members and their associated persons are prohibited from guaranteeing any customer against loss in connection with any securities transaction or in any securities account of such customer. In addition, NASD is proposing that associated persons obtain written authorization from their employing member firm and the customer prior to sharing in a customer’s account under Rule 2330(f). The proposed rule change to Rule 2330(f) also deletes the requirement that members and associated persons obtain the written authorization of the member carrying the account prior to sharing in a customer’s account. Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

* * * * *

2330. Customers’ Securities or Funds

(a) through (d) No Change.

(e) Prohibition Against Guarantees

No member or person associated with a member shall guarantee a customer against loss in connection with any securities [account] transaction or in any securities account of such customer [carried by the member or in any securities transaction effected by the member with or for such customer].

¹ 15 U.S.C. 78s(b)(1).

(f) Sharing in Accounts: Extent Permissible

(1)(A) Except as provided in paragraph (f)(2) no member or person associated with a member shall share directly or indirectly in the profits or losses in any account of a customer carried by the member or any other member; provided, however, that a member or person associated with a member may share in the profits or losses in such an account if (i) such [member or] person associated with a member obtains prior written authorization from the member [carrying the account] employing the associated person; (ii) such member or person associated with a member obtains prior written authorization from the customer; and (iii) [the] such member or person associated with a member [shall] shares in the profits or losses in any account of such customer only in direct proportion to the financial contributions made to such account by either the member or person associated with a member.

(B) Exempt from the direct proportionate share limitation of paragraph (f)(1)(A)(iii) are accounts of the immediate family of such member or person associated with a member. For purposes of this Rule, the term “immediate family” shall include parents, mother-in-law or father-in-law, husband or wife, children or any relative to whose support the member or person associated with a member otherwise contributes directly or indirectly.

(2) Notwithstanding the prohibition of paragraph (f)(1), a member or person associated with a member that is acting as an investment adviser (whether or not registered as such) may receive compensation based on a share in profits or gains in an account if (i) [the member or] such person associated with a member seeking such compensation obtains prior

written authorization from the member [carrying the account] employing the associated person; (ii) such member or person associated with a member seeking such compensation obtains prior written authorization from the customer;[,] and (iii) all of the conditions in Rule 205-3 of the Investment Advisers Act of 1940 (as the same may be amended from time to time) are satisfied.

* * * * *

(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, Inc. at its meeting on September 25, 2002, which authorized the filing of the rule change with the SEC. Counsel for The Nasdaq Stock Market, Inc. and NASD Dispute Resolution, Inc. 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 at its meeting on September 26, 2002. 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 amend 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 30 days following publication of the Notice to Members announcing Commission approval.

(b) Questions regarding this rule filing may be directed to Afshin Atabaki, Attorney, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8902.

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

(a) Purpose

The proposed rule change amends NASD rules regarding the prohibition against guarantees and requirements governing sharing in customer accounts. Earlier this year, in response to requests for interpretive guidance, NASD reviewed the application of these rules. Based on its review, NASD is proposing changes to these rules to clarify their scope and enhance their effectiveness.

Rule 2330(e) – Prohibition Against Guarantees

NASD Rule 2330(e) currently prohibits a member or its associated persons from guaranteeing a customer against loss in any customer's account that is carried by the member and in any securities transaction effected by the member with or for the customer. A strict reading of the rule would limit its application to only those guarantees made by the member (or the member's associated persons) carrying the customer's account and those guarantees made by the member (or the member's associated persons) effecting a securities transaction with or for the customer. Consequently, guarantees such as those made by an associated person to customers whose accounts are not carried by that associated person's member potentially would not be prohibited under this reading of the rule. Similarly, guarantees made by an associated person to customers whose securities transactions are not effected by that associated person's member potentially would not be prohibited under this strict reading.

NASD proposes to amend Rule 2330(e) to clarify that the rule prohibits a member and its associated persons from making guarantees to any customer because such guarantees create the expectation that the customer is insulated from market risk intrinsic in securities ownership and may induce the customer to engage in a securities transaction that is not otherwise appropriate for the customer. Even prior to the adoption of Rule 2330(e) (formerly Article III, Section 19(e) of the NASD Rules of Fair Practice), the SEC stated, with respect to guarantees, that “the observance of just and equitable principles of trade does not permit the use of statements which lead an unwary purchaser to the mistaken belief that his transactions are free of risk.”²

The proposed rule change will clarify that members and their associated persons are prohibited from making guarantees to any customer, not just those customers whose accounts are carried by the member or those customers for whom a member is effecting a securities transaction.³

Rule 2330(f) – Sharing in Accounts

NASD Rule 2330(f) currently prohibits members and associated persons from sharing in the profits or losses in a customer’s account except under certain limited conditions.⁴ Rule

² Philips & Company, 37 S.E.C. 66, 71 (1956).

³ The proposed rule change is not, however, intended to affect the types of guarantees that currently are permitted under the rule; rather, the proposed amendment seeks to clarify the circumstances under which certain guarantees would be prohibited. For example, a “guarantee” that is extended to all holders of a particular security by an issuer as part of that security generally would not be prohibited under Rule 2330(e).

⁴ For example, this provision formed the basis of an NASD enforcement action

2330(f)(1)(A) permits a member or person associated with a member to share in the profits or losses in a customer's account if such member or person associated with a member obtains prior written authorization from the member that is carrying the account and the sharing is proportionate to the member's or associated person's contributions to the account. NASD Rule 2330(f)(2) permits a member or person associated with a member that acts as an investment adviser to receive compensation based on a share in the profits or gains in a customer's account if such member or person associated with a member obtains prior written authorization from the member that is carrying the account, and the conditions specified in Rule 205-3 under the Investment Advisers Act of 1940 are satisfied.

Currently, both Rule 2330(f)(1)(A) and Rule 2330(f)(2) require the member or associated person that is sharing in the profits or losses in a customer's account to obtain the prior written authorization of the member that is carrying the account. These rules do not necessarily require an associated person to obtain the prior written authorization of his or her employing member when sharing in the profits or losses in a customer's account. Employing members only would be notified if they also were the carrying member of the account or if the arrangement triggered application of another NASD rule, e.g., Rules 3030 (Outside Business Activities of an Associated Person), 3040 (Private Securities Transactions of an

against Credit Suisse First Boston, Inc. in which NASD found that Credit Suisse First Boston's practice of sharing in the profits in customers' accounts in exchange for allocating initial public offering securities to such customers violated Rule 2330(f). In January 2002, Credit Suisse First Boston settled this matter without admitting or denying the allegations. See Credit Suisse First Boston Corporation, Letter of Acceptance, Waiver and Consent, No. CAF020001 (Jan. 22, 2002).

Associated Person), or 3050 (Transactions for or by Associated Persons).⁵ NASD believes that the current requirement of receiving authorization from (and only from) the carrying member of the customer account in which a member or associated person intends to share is not the most effective regulatory approach to address the potential risks of such arrangements. NASD believes that it is important that employing members be notified and affirmatively authorize sharing in a customer's account so that they are better able to supervise their associated persons and ensure compliance with NASD rules and other applicable laws and regulations.

In addition, neither Rule 2330(f)(1)(A) nor Rule 2330(f)(2) require a member or its associated persons to obtain the prior written authorization of the customer in whose account they intend to share. NASD believes that it is important for a customer to provide his or her written approval prior to a member or its associated persons sharing in the profits or losses in that customer's account. NASD believes that it is important that customers be provided the opportunity to affirmatively authorize a member or associated person to share in their accounts.

Therefore, NASD is proposing to amend Rules 2330(f)(1)(A) and 2330(f)(2) to require that, when sharing in a customer's account, associated persons obtain the prior written

⁵ Rule 3030, among other things, requires that associated persons notify their employer member of any business activity outside the scope of their relationship with the member. Rule 3040, among other things, requires that associated persons obtain written approval from their employer member before engaging in any securities transaction for which they have or may receive selling compensation outside the regular course or scope of their employment with the member. Rule 3050, among other things, requires an associated person to notify his or her employer member in writing prior to opening an account or placing an initial order for the purchase or sale of securities with another member and to notify that member in writing of his or her employment relationship with the employer member.

authorization of their employing member and that members and their associated persons obtain the prior written authorization of the customer in whose account they will be sharing. NASD notes that, notwithstanding a member's or associated person's compliance with the requirements of Rule 2330(f), the conduct permitted under Rule 2330(f) may trigger notice and other requirements under other NASD rules, including NASD Rules 3030, 3040, and 3050. Rule 2330(f) does not affect the applicability of such other rules to these arrangements.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,⁶ which requires, among other things, that NASD rules 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. Specifically, the proposed rule change is intended to facilitate compliance with Rule 2330(e) by clarifying the conduct prohibited by the rule, and to strengthen the regulatory protections provided in Rule 2330(f).

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 15 U.S.C. 78o-3(b)(6).

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

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. 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: December 17, 2002

⁷ 15 U.S.C. 78s(b)(2).

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34- ; File No. SR-NASD-2002-180)

December , 2002

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Regarding Prohibition Against Guarantees and Sharing in Customer Accounts

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 , 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 Rule 2330(e) to clarify that members and their associated persons are prohibited from guaranteeing any customer against loss in connection with any securities transaction or in any securities account of such customer. In addition, NASD is proposing that associated persons obtain written authorization from their employing member firm and the customer prior to sharing in a customer’s account under Rule 2330(f). The proposed rule change to Rule 2330(f) also deletes the requirement that members and associated persons obtain the written authorization of the member carrying the account prior

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

to sharing in a customer's account. Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

* * * * *

2330. Customers' Securities or Funds

(a) through (d) No Change.

(e) Prohibition Against Guarantees

No member or person associated with a member shall guarantee a customer against loss in connection with any securities [account] transaction or in any securities account of such customer [carried by the member or in any securities transaction effected by the member with or for such customer].

(f) Sharing in Accounts: Extent Permissible

(1)(A) Except as provided in paragraph (f)(2) no member or person associated with a member shall share directly or indirectly in the profits or losses in any account of a customer carried by the member or any other member; provided, however, that a member or person associated with a member may share in the profits or losses in such an account if (i) such [member or] person associated with a member obtains prior written authorization from the member [carrying the account] employing the associated person; (ii) such member or person associated with a member obtains prior written authorization from the customer; and (iii) [the] such member or person associated with a member [shall] shares in the profits or losses in any account of such customer only in direct proportion to the financial contributions made to such account by either the member or person associated with a member.

(B) Exempt from the direct proportionate share limitation of paragraph (f)(1)(A)(iii) are accounts of the immediate family of such member or person associated with a member. For purposes of this Rule, the term “immediate family” shall include parents, mother-in-law or father-in-law, husband or wife, children or any relative to whose support the member or person associated with a member otherwise contributes directly or indirectly.

(2) Notwithstanding the prohibition of paragraph (f)(1), a member or person associated with a member that is acting as an investment adviser (whether or not registered as such) may receive compensation based on a share in profits or gains in an account if (i) [the member or] such person associated with a member seeking such compensation obtains prior written authorization from the member [carrying the account] employing the associated person; (ii) such member or person associated with a member seeking such compensation obtains prior written authorization from the customer;[.] and (iii) all of the conditions in Rule 205-3 of the Investment Advisers Act of 1940 (as the same may be amended from time to time) are satisfied.

* * * * *

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. NASD has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(1) Purpose

The proposed rule change amends NASD rules regarding the prohibition against guarantees and requirements governing sharing in customer accounts. Earlier this year, in response to requests for interpretive guidance, NASD reviewed the application of these rules. Based on its review, NASD is proposing changes to these rules to clarify their scope and enhance their effectiveness.

Rule 2330(e) – Prohibition Against Guarantees

NASD Rule 2330(e) currently prohibits a member or its associated persons from guaranteeing a customer against loss in any customer's account that is carried by the member and in any securities transaction effected by the member with or for the customer. A strict reading of the rule would limit its application to only those guarantees made by the member (or the member's associated persons) carrying the customer's account and those guarantees made by the member (or the member's associated persons) effecting a securities transaction with or for the customer. Consequently, guarantees such as those made by an associated person to customers whose accounts are not carried by that associated person's member potentially would not be prohibited under this reading of the rule. Similarly, guarantees made by an associated person to customers whose securities transactions are not effected by that associated person's member potentially would not be prohibited under this strict reading.

NASD proposes to amend Rule 2330(e) to clarify that the rule prohibits a member and its associated persons from making guarantees to any customer because such guarantees create the expectation that the customer is insulated from market risk intrinsic in securities

ownership and may induce the customer to engage in a securities transaction that is not otherwise appropriate for the customer. Even prior to the adoption of Rule 2330(e) (formerly Article III, Section 19(e) of the NASD Rules of Fair Practice), the SEC stated, with respect to guarantees, that “the observance of just and equitable principles of trade does not permit the use of statements which lead an unwary purchaser to the mistaken belief that his transactions are free of risk.”³

The proposed rule change will clarify that members and their associated persons are prohibited from making guarantees to any customer, not just those customers whose accounts are carried by the member or those customers for whom a member is effecting a securities transaction.⁴

Rule 2330(f) – Sharing in Accounts

NASD Rule 2330(f) currently prohibits members and associated persons from sharing in the profits or losses in a customer’s account except under certain limited conditions.⁵

³ Philips & Company, 37 S.E.C. 66, 71 (1956).

⁴ The proposed rule change is not, however, intended to affect the types of guarantees that currently are permitted under the rule; rather, the proposed amendment seeks to clarify the circumstances under which certain guarantees would be prohibited. For example, a “guarantee” that is extended to all holders of a particular security by an issuer as part of that security generally would not be prohibited under Rule 2330(e).

⁵ For example, this provision formed the basis of an NASD enforcement action against Credit Suisse First Boston, Inc. in which NASD found that Credit Suisse First Boston’s practice of sharing in the profits in customers’ accounts in exchange for allocating initial public offering securities to such customers violated Rule 2330(f). In January 2002, Credit Suisse First Boston settled this matter without admitting or denying the allegations. See Credit Suisse First Boston Corporation, Letter of Acceptance, Waiver and Consent, No. CAF020001 (Jan. 22, 2002).

Rule 2330(f)(1)(A) permits a member or person associated with a member to share in the profits or losses in a customer's account if such member or person associated with a member obtains prior written authorization from the member that is carrying the account and the sharing is proportionate to the member's or associated person's contributions to the account. NASD Rule 2330(f)(2) permits a member or person associated with a member that acts as an investment adviser to receive compensation based on a share in the profits or gains in a customer's account if such member or person associated with a member obtains prior written authorization from the member that is carrying the account, and the conditions specified in Rule 205-3 under the Investment Advisers Act of 1940 are satisfied.

Currently, both Rule 2330(f)(1)(A) and Rule 2330(f)(2) require the member or associated person that is sharing in the profits or losses in a customer's account to obtain the prior written authorization of the member that is carrying the account. These rules do not necessarily require an associated person to obtain the prior written authorization of his or her employing member when sharing in the profits or losses in a customer's account. Employing members only would be notified if they also were the carrying member of the account or if the arrangement triggered application of another NASD rule, e.g., Rules 3030 (Outside Business Activities of an Associated Person), 3040 (Private Securities Transactions of an Associated Person), or 3050 (Transactions for or by Associated Persons).⁶ NASD believes

⁶ Rule 3030, among other things, requires that associated persons notify their employer member of any business activity outside the scope of their relationship with the member. Rule 3040, among other things, requires that associated persons obtain written approval from their employer member before engaging in any securities transaction for which they have or may receive selling compensation outside the regular course or scope of their employment with the member. Rule 3050, among other things, requires an associated person to notify his or her employer member in writing prior to opening an account or placing an initial order for the purchase or sale

that the current requirement of receiving authorization from (and only from) the carrying member of the customer account in which a member or associated person intends to share is not the most effective regulatory approach to address the potential risks of such arrangements. NASD believes that it is important that employing members be notified and affirmatively authorize sharing in a customer's account so that they are better able to supervise their associated persons and ensure compliance with NASD rules and other applicable laws and regulations.

In addition, neither Rule 2330(f)(1)(A) nor Rule 2330(f)(2) require a member or its associated persons to obtain the prior written authorization of the customer in whose account they intend to share. NASD believes that it is important for a customer to provide his or her written approval prior to a member or its associated persons sharing in the profits or losses in that customer's account. NASD believes that it is important that customers be provided the opportunity to affirmatively authorize a member or associated person to share in their accounts.

Therefore, NASD is proposing to amend Rules 2330(f)(1)(A) and 2330(f)(2) to require that, when sharing in a customer's account, associated persons obtain the prior written authorization of their employing member and that members and their associated persons obtain the prior written authorization of the customer in whose account they will be sharing. NASD notes that, notwithstanding a member's or associated person's compliance with the requirements of Rule 2330(f), the conduct permitted under Rule 2330(f) may trigger notice and other requirements under other NASD rules, including NASD Rules 3030, 3040, and

of securities with another member and to notify that member in writing of his or her employment relationship with the employer member.

3050. Rule 2330(f) does not affect the applicability of such other rules to these arrangements.

(2) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,⁷ which requires, among other things, that NASD rules 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. Specifically, the proposed rule change is intended to facilitate compliance with Rule 2330(e) by clarifying the conduct prohibited by the rule, and to strengthen the regulatory protections provided in Rule 2330(f).

(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

⁷ 15 U.S.C. 78o-3(b)(6).

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 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.⁸

Margaret H. McFarland
Deputy Secretary

⁸ 17 CFR 200.30-3(a)(12).