

# Notice to Members

APRIL 2003

## SUGGESTED ROUTING

Executive Representatives  
Legal & Compliance  
Senior Management  
Registered Representatives  
Principals

## KEY TOPICS

NASD Rule 2330  
Guarantees Against Loss  
Sharing in Customer Accounts

## INFORMATIONAL

### Prohibition Against Guarantees and Sharing in Customer Accounts

SEC Approves Amendments to NASD Rules Regarding Prohibition Against Guarantees and Sharing in Customer Accounts; **Effective Date: May 12, 2003**

#### Executive Summary

On February 12, 2003, the Securities and Exchange Commission (SEC) approved amendments to NASD Rules 2330(e) (Prohibition Against Guarantees) and 2330(f) (Sharing in Accounts; Extent Permissible).<sup>1</sup> The amendments to Rule 2330(e) 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 the customer. Rule 2330(f) has been amended to require that associated persons obtain prior written authorization from their employing member firm and that members and associated persons obtain prior written authorization from the customer before sharing in a customer's account. The amendments also delete from Rule 2330(f) the requirement that members and associated persons obtain the prior written authorization of the member carrying the account before sharing in a customer's account. The text of these amendments are set forth in Attachment A.

#### Questions/Further Information

Questions concerning this *Notice* may be directed to Afshin Atabaki, Attorney, Office of General Counsel, NASD Regulatory Policy and Oversight, at (202) 728-8902.

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## Discussion

In response to requests for interpretive guidance, NASD has amended Rules 2330(e) and 2330(f) as described below to clarify their scope and enhance their effectiveness.

### **Rule 2330(e) – Prohibition Against Guarantees**

Previously, NASD Rule 2330(e) prohibited a member or its associated persons from guaranteeing a customer against loss in any customer's account that was carried by the member and in any securities transaction effected by the member with or for the customer. A strict reading of that rule would have limited 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.

NASD has amended Rule 2330(e) to clarify that the rule prohibits a member and its associated persons 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. The reason for the prohibition is that 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.<sup>2</sup>

### **Rule 2330(f) – Sharing in Accounts**

NASD Rule 2330(f) prohibits members and associated persons from sharing in the profits or losses in a customer's account except under certain limited conditions.<sup>3</sup> Rule 2330(f)(1)(A) permitted 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 obtained prior written authorization from the member that was carrying the account and the sharing was proportionate to the member's or associated person's contributions to the account. NASD Rule 2330(f)(2) permitted a member or person associated with a member that acted 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 obtained prior written authorization from the member that was carrying the account, and the conditions specified in Rule 205-3 under the Investment Advisers Act of 1940 were satisfied.

Both Rule 2330(f)(1)(A) and Rule 2330(f)(2) required the member or associated person that was sharing in the profits or losses in a customer's account to obtain the prior written authorization of the member that was carrying the account. These rules did 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

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Securities Transactions of an Associated Person), or 3050 (Transactions for or by Associated Persons).<sup>4</sup> In addition, neither Rule 2330(f)(1)(A) nor Rule 2330(f)(2) required a member or its associated persons to obtain the prior written authorization of the customer in whose account they intended 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 that customer's account. Further, employing members should 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.

Therefore, NASD has amended 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 addition, Rule 2330(f) has been amended to remove the requirement that members and associated persons obtain the written authorization of the member carrying the account before sharing in a customer's account. 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.

## Endnotes

- 1 See Securities Exchange Act Release No. 47354 (February 12, 2003), 68 FR 8053 (February 19, 2003) (order approving File No. SR-NASD-2002-180).
- 2 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).
- 3 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).
- 4 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.

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## ATTACHMENT A

New language is underlined; 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] share 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.

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(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.