

September 1, 1999

Richard C. Strasser, Esq.
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549
Mail Stop 10-1

Re: **File No. SR-NASD-99-42** - Proposed Rule Change relating to Performance Fee Arrangements

Dear Mr. Strasser:

Pursuant to Rule 19b-4, enclosed herewith is 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 Stephanie M. Dumont, Office of General Counsel, NASD Regulation, Inc., at (202) 728-8176; e-mail stephanie.dumont@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Joan C. Conley
Senior Vice President
and Corporate Secretary

Attachment

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) under the Securities Exchange Act of 1934 (“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 Rule 2330(f)(2) of the NASD in order to make it consistent with recent amendments by the SEC to Rule 205-3 of the Investment Advisers Act of 1940 (“Rule 205-3”). Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in [brackets].

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RULES OF THE ASSOCIATION

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2300. TRANSACTIONS WITH CUSTOMERS

2330. Customers’ Securities or Funds

(a) through (e) (No change)

(f) Sharing in Accounts; Extent Permissible

(1)(A) and (B)(No change)

(2) Notwithstanding the prohibition of paragraph (f)(1), a member or person associated with a member may receive compensation based on a share in profits or gains in an account if [all of] the following conditions are satisfied:*

* It is the position of the Division of Investment Management of the Commission that compensation received by a member or person associated with a member under this Rule would constitute “special compensation” for purposes of the broker/dealer exception to the definition of “investment adviser” in Section 202(a)(11)(C) of the Investment Advisers Act of 1940 (Advisers Act). Any member or person associated with a member, required to be registered under the Advisers Act, or state law, who (continues to next page. . .)

(A) The member or person associated with a member seeking such compensation obtains prior written authorization from the member carrying the account; and

(B) The compensation arrangement complies with the conditions set forth in any applicable rule promulgated by the Commission.

[(B) The customer has at the time the account is opened either a net worth which the member or person associated with a member reasonably believes to be not less than \$1,000,000, or the minimum amount invested in the account is not less than \$500,000;

(C) The member or person associated with a member reasonably believes the customer is able to understand the proposed method of compensation and its risks prior to entering into the arrangement;

(D) The compensation arrangement is set forth in a written agreement executed by the customer and the member;

(E) The member or person associated with a member reasonably believes, immediately prior to entering into the arrangement, that the agreement represents an arm's-length arrangement between the parties;

(F) The compensation formula takes into account both gains and losses realized or accrued in the account over a period of at least one year; and

(G) The member has disclosed to the customer all material information relating to the arrangement including the method of compensation and potential conflicts of interest which may result from the compensation formula.]

receives compensation based on a share of profits or capital appreciation of a customer's account must comply with Section 205(l) and Rule 205-3 under the Advisers Act, or applicable state law, with respect to such compensation. (SEC Release 34-24355, 52 Fed. Reg. 13778, April 24, 1987).

(continues to next page. . .)

* * *

(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 July 23, 1999, which authorized the filing of the rule change with the SEC. The NASD Board of Governors had an opportunity to review the proposed rule change at its meeting on July 29, 1999. The Nasdaq Stock Market has 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. 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 Stephanie M. Dumont, Assistant General Counsel, NASD Regulation, Office of General Counsel, at (202) 728-8176.

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

(a) Purpose

Description of Proposed Rule Change

Rule 2330(f) prohibits members or registered representatives from sharing in customer account profits except under certain conditions. Subparagraph (f)(1)(A) permits sharing in customer account profits where the firm has authorized it and the sharing is proportionate to the member's or associated person's contributions to the account. Subparagraph (f)(2) permits, under certain conditions, members or registered representatives to charge a performance fee (an advisory fee based on a percentage of the capital gains or capital appreciation of an account). Currently, Rule 2330(f)(2) permits the receipt of a performance fee only if: (i) the customer account meets certain minimum net worth (\$1,000,000) and amount invested (\$500,000) requirements; (ii) the member or associated person obtains the prior written authorization of the arrangement from the member carrying the account; (iii) the associated person reasonably believes that the customer is able to understand the compensation arrangement and its risks; (iv) the compensation agreement is in writing; (v) it is an arm's length agreement; (vi) the compensation formula takes into account realized and accrued gains and losses over a period of at least one year; and (vii) the member discloses all material information relating to the agreement, including method of compensation and potential conflicts of interest.

The requirements of Rule 2330(f)(2) have always closely tracked the requirements in SEC Rule 205-3. However, effective August 20, 1998, the SEC amended Rule 205-3 to provide greater flexibility in structuring performance fee arrangements with clients who are financially sophisticated or have the resources to obtain sophisticated financial advice regarding these

arrangements.¹ The amendments to Rule 205-3 either changed or eliminated many of the requirements tracked in Rule 2330(f)(2). As a result of these changes, NASD Rule 2330(f)(2) is now inconsistent with SEC Rule 205-3.

In order to restore consistency, the proposed rule change will permit members and their associated persons to share in customer account profits subject to the conditions in Rule 205-3. Thus, in the future, the proposed rule will conform to any subsequent amendments by the SEC to Rule 205-3.

(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 NASD Regulation believes that the proposed rule change will protect investors and the public interest by ensuring that performance fee arrangements are consistent with SEC Rules and are structured with clients who are financially sophisticated or have the resources to obtain sophisticated financial advice regarding the terms of such arrangements.

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.

¹ 63 Fed. Reg. 39022 (July 21, 1998).

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

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: _____

Joan C. Conley
Senior Vice President and Corporate Secretary

Date: September 1, 1999

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RULES OF THE ASSOCIATION

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2300. TRANSACTIONS WITH CUSTOMERS

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(a) through (e) (No change)

(f) **Sharing in Accounts; Extent Permissible**

(1)(A) and (B)(No change)

(2) Notwithstanding the prohibition of paragraph (f)(1), a member or person associated with a member may receive compensation based on a share in profits or gains in an account if [all of] the following conditions are satisfied:*

(A) The member or person associated with a member seeking such compensation obtains prior written authorization from the member carrying the account; and

(B) The compensation arrangement complies with the conditions set forth in any applicable rule promulgated by the Commission.

[(B) The customer has at the time the account is opened either a net worth which the member or person associated with a member reasonably believes to be not

* It is the position of the Division of Investment Management of the Commission that compensation received by a member or person associated with a member under this Rule would constitute "special compensation" for purposes of the broker/dealer exception to the definition of "investment adviser" in Section 202(a)(11)(C) of the Investment Advisers Act of 1940 (Advisers Act). Any member or person associated with a member, required to be registered under the Advisers Act, or state law, who receives compensation based on a share of profits or capital appreciation of a customer's account must comply with Section 205(l) and Rule 205-3 under the Advisers Act, or applicable state law, with respect to such compensation. (SEC Release 34-24355, 52 Fed. Reg. 13778, April 24, 1987).

less than \$1,000,000, or the minimum amount invested in the account is not less than \$500,000;

(C) The member or person associated with a member reasonably believes the customer is able to understand the proposed method of compensation and its risks prior to entering into the arrangement;

(D) The compensation arrangement is set forth in a written agreement executed by the customer and the member;

(E) The member or person associated with a member reasonably believes, immediately prior to entering into the arrangement, that the agreement represents an arm's-length arrangement between the parties;

(F) The compensation formula takes into account both gains and losses realized or accrued in the account over a period of at least one year; and

(G) The member has disclosed to the customer all material information relating to the arrangement including the method of compensation and potential conflicts of interest which may result from the compensation formula.]

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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 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

Description of Proposed Rule Change

Rule 2330(f) prohibits members or registered representatives from sharing in customer account profits except under certain conditions. Subparagraph (f)(1)(A) permits sharing in customer account profits where the firm has authorized it and the sharing is proportionate to the member's or associated person's contributions to the account. Subparagraph (f)(2) permits, under certain conditions, members or registered representatives to charge a performance fee (an advisory fee based on a percentage of the capital gains or capital appreciation of an account). Currently, Rule 2330(f)(2) permits the receipt of a performance fee only if: (i) the customer account meets certain minimum net worth (\$1,000,000) and amount invested (\$500,000) requirements; (ii) the member or associated person obtains the prior written authorization of the arrangement from the member carrying the account; (iii) the associated person reasonably believes that the customer is able to understand the compensation arrangement and its risks; (iv) the compensation agreement is in writing; (v) it is an arm's length agreement; (vi) the compensation formula takes into account realized and accrued gains and losses over a period of at least one year; and (vii) the member discloses all material information relating to the agreement, including method of compensation and potential conflicts of interest.

The requirements of Rule 2330(f)(2) have always closely tracked the requirements in SEC Rule 205-3. However, effective August 20, 1998, the SEC amended Rule 205-3 to provide greater flexibility in structuring performance fee arrangements with clients who are financially sophisticated or have the resources to obtain sophisticated financial advice regarding these arrangements.¹ The amendments to Rule 205-3 either changed or eliminated many of the requirements tracked in Rule 2330(f)(2). As a result of these changes, NASD Rule 2330(f)(2) is now inconsistent with SEC Rule 205-3.

In order to restore consistency, the proposed rule change will permit members and their associated persons to share in customer account profits subject to the conditions in Rule 205-3. Thus, in the future, the proposed rule will conform to any subsequent amendments by the SEC to Rule 205-3.

(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. NASD Regulation believes that the proposed rule change will protect investors and the public interest by ensuring that performance fee arrangements are consistent with SEC Rules and are structured with clients who are financially sophisticated or have the resources to obtain sophisticated financial advice regarding the

¹ 63 Fed. Reg. 39022 (July 21, 1998).

terms of such arrangements.

(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