

January 30, 2001

Ms. 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-99-42 - Amendment No. 1; Proposed Rule Change Relating to
Performance Fee Arrangements**

Dear Ms. England:

NASD Regulation, Inc. ("NASD Regulation") hereby submits Amendment No. 1 to SR-NASD-99-42. NASD Regulation is proposing to amend Rule 2330(f)(2) to clarify that only those members acting in the capacity of an investment adviser, whether or not registered as such, may receive compensation based on a share of the profits or gains in an account. Further, to receive such compensation, all of the conditions in Rule 205-3 of the Investment Advisers Act of 1940 ("Rule 205-3"), as may be amended from time to time, must be satisfied. The attached proposed rule language incorporates the amendments described herein.

In addition, NASD Regulation will include in a *Notice to Members* to be published upon Securities and Exchange Commission ("SEC") approval of the proposed rule change, the specific conditions in Rule 205-3 that must be complied with under Rule 2330(f)(2). If the SEC amends Rule 205-3 in the future, NASD Regulation will notify its members of these amendments in a *Notice to Members* within 90 days of the SEC's announcement of its rule change.

If you have any questions, please contact Stephanie Dumont, Office of General Counsel, NASD Regulation, at (202) 728-8176. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Jeffrey S. Holik

Attachment

Attachment
SR-NASD-99-42 -- Proposed Rule Language (as amended)

Below is the text of the proposed rule change incorporating the proposed amendments described in Amendment No. 1 to File No. SR-NASD-99-42. Proposed new language is underlined; proposed deletions are in brackets.

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 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 [all of the following conditions are satisfied:*

[(A) T] the member or person associated with a member seeking such compensation obtains prior written authorization from the member carrying the account[;], and 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.

[* 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 exception to the definition of "investment advisor" 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(1) 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).]

[(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.]