

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

1. Purpose

Rule Modernization

In July 2001, NASD announced in Notice to Members 01-35 its intention to move forward with an initiative designed to ensure that NASD rules are as streamlined as possible and impose the least burden necessary to accomplish their objectives while achieving investor protection. In response to Notice to Members 01-35, some commenters asked NASD to review NASD Conduct rule 2260 to consider expanding the categories of persons to whom a member may forward proxy and other materials.

Based on the research and analysis of NASD Conduct rule 2260 conducted by NASD staff and the Economic Advisory Board ("EAB"), which was formed by NASD to assist with an economic analysis of certain NASD rules, the EAB made a formal recommendation to expand the definition of "designated investment adviser" in NASD Conduct rule 2260 to include all state registered investment advisers.

Proposed Expansion

Currently, NASD Conduct rule 2260 requires members to forward proxy material, annual reports, information statements and other material sent to security holders to the beneficial owner or the beneficial owner's "designated investment adviser."⁶ The rule defines a "designated investment adviser" as a person registered under the Investment Advisers Act of 1940 ("Advisers Act") who exercises investment discretion pursuant to an advisory contract for the beneficial owner and is designated in writing by the beneficial owner to receive proxy and related materials and vote the proxy, and to receive annual reports and other material sent to security holders.

NASD Conduct rule 2260 was amended in 1995 to include federally registered investment advisers.⁷ However, as a result of the passage in 1996 of the National Securities Markets Improvement Act ("NSMIA"), certain state registered investment advisers

need not be registered under the Advisers Act.⁸ NASD Conduct rule 2260 was not updated to account for this change. As a result, under the current rule, beneficial owners cannot designate state registered investment advisers to receive proxy and other materials. The proposed rule change would expand the definition of "designated investment adviser" to include persons registered under the Advisers Act and persons registered by a state as an investment adviser.

NASD believes that the current exclusion of state registered investment advisers serves no valid investor protection purpose. NASD Conduct rule 2260 will continue to require that the beneficial owner execute a written designation addressed to the member that includes the name of the designated investment adviser. The beneficial owner will continue to have an unqualified right at anytime to rescind designation of the investment adviser to receive materials and to vote proxies. The recession must be in writing and submitted to the member.

The proposed rule change will continue to require that a member that receives a written designation from a beneficial owner must ensure that the beneficial owner's designated investment adviser is registered under the Advisers Act or, for state registered investment advisers, is registered as an investment adviser under the laws of the state. A member may verify registration of an investment adviser through the use of the Investment Adviser Registration Depository ("IARD") system. Under the proposed rule change, members must continue to ensure that the designated investment adviser is exercising investment discretion pursuant to an advisory contract for the beneficial owner; and is designated in writing by the beneficial owner to receive and vote proxies for stock that is in the possession of the members. Members also must continue

to keep records substantiating this information.

The Commission notes that the New York Stock Exchange, Inc. has filed a similar proposed rule change.⁹

2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of section 15A(b)(6) of the Act,¹⁰ which requires, among other things, that NASD'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 believes that the proposed rule change to expand the definition of "designated investment adviser" in NASD Conduct rule 2260 is designed to accomplish these ends by updating NASD Conduct rule 2260 to be consistent with the goals of NSMIA and to address an inconsistency in the treatment of Federally-registered versus State-registered investment advisers that does not serve a valid investor protection purpose.

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 for this proposed rule change. In connection with its rule modernization initiative, NASD issued Notice to Members 02-10 (January 2002) that surveyed members on a broad range of topics that included subject matter related to this rule proposal. However, as NASD views the responses received as general survey material, it is not included in this filing.

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:

⁹ See Exchange Act Release No. 47215 (January 21, 2003).

¹⁰ 15 U.S.C. 78o-3(b)(6).

⁸ National Securities Markets Improvement Act of 1996, Pub.L. No. 104-290, 110 Stat. 3416 (1996). The Commission notes that title III of NSMIA (a/k/a The Investment Advisers Supervision Coordination Act) provides for Commission regulation of advisers with \$25 million or more of assets under management, and state regulation of advisers with less than \$25 million of assets under management. The Commission also notes that new section 203A(a) of the Advisers Act provides that an investment adviser that is regulated or required to be regulated as an investment adviser in the state in which it maintains its principal office and place of business is prohibited from registering with the Commission unless the adviser:

(i) Has assets under management of not less than \$25 million (or such higher amount as the Commission may, by rule, deem appropriate), or

(ii) Is an advisor to an investment company registered under the Investment Company Act of 1940. 15 U.S.C. 80b-3a.

⁶ In April 2002, the SEC approved a proposed rule change to NASD Conduct rule 2260 making its provisions applicable to non-municipal debt securities. The rule change became effective on July 9, 2002. See Securities Exchange Act Release No. 45736 (April 11, 2002), 67 FR 19291 (April 18, 2002) (SR-NASD-2002-11).

⁷ See Securities Exchange Act Release No. 35681 (May 5, 1995), 60 FR 25749 (May 15, 1995) (SR-NASD-95-06).