

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.

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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 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

³ *In the Matter of 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).

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 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

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. CAF020002 (Jan. 22, 2002).

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,