Funds will soon become subject to the performance-based compensation restrictions of section 205(a)(1) of the Advisers Act, and will accordingly look to Advisers Act rule 205–3 to continue charging performance-based compensation, as discussed below. Superior therefore seeks relief that will allow it to invest in Superior Third Party Funds notwithstanding the fact that some of Superior's partners are not ''qualified clients'' as required by rule 205–3.

11. Superior's four Managing General Partners are all ''qualified clients'' for purposes of rule 205–3, as are 32 other Current Superior Partners. The 23 other Current Superior Partners do not meet the definition of a qualified client. Superior may admit Future Superior Partners that may not be qualified clients.

Applicants' Legal Analysis

1. Section 205(a)(1) of the Advisers Act generally prohibits a registered investment adviser, unless exempt from registration pursuant to section 203(b) of the Act, from entering into, extending, renewing, or performing under any investment advisory contract that provides for compensation based upon ''a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client,'' commonly referred to as performance-based compensation or a performance fee.

2. Rule 205–3 under the Act provides an exemption from the prohibition in section 205(a)(1), provided each client entering into an investment advisory contract that provides for performance-based compensation is a ''qualified client.'' Under rule 205–3(b), each equity owner of a ''private investment company'' is considered a client for purposes of rule 205–3(a).[4] Applicants assert that Greenhouse and Superior are private investment companies.

3. Because a number of the Current Greenhouse Members and Current Superior Partners are not qualified clients, Applicants may not be treated as meeting the requirements of rule 205–3(a).

4. Applicants request an order under section 205(e) of the Advisers Act granting an exemption from section 205(a)(1) of the Act so as to permit registered investment advisers to charge Applicants performance-related compensation. Applicants ask that the relief requested be applicable to Current Greenhouse Members and Current Superior Partners that are not qualified clients, as well as to Future Greenhouse Members and Future Superior Partners that are not qualified clients.

5. Section 205(e) of the Advisers Act provides that the Commission, by order upon application, may exempt any person, or any class or classes of persons, from section 205(a)(1) of the Act, if and to the extent that the exemption relates to an investment advisory contract with any person that the Commission determines does not need the protection of section 205(a)(1), on the basis of such factors as financial sophistication, net worth, knowledge of and experience in financial matters, and such other factors as the Commission determines are consistent with section 205.

6. Applicants assert that exemptive relief to permit Greenhouse and Superior to be charged performance-based compensation is appropriate and consistent with the purposes of 205(a)(1) of the Advisers Act. Applicants assert that the request for relief complies with the factors specified in section 205(e) of the Act. Applicants state that Mr. Dudley and Mr. Shanley, the investment decision-makers for Applicants, are qualified clients meeting the net worth requirement of rule 205–3(d)(1)(ii)(A) under the Act. Superior further asserts that each of its Managing General Partners with whom Mr. Dudley and Mr. Shanley periodically consult is a qualified client. Applicants assert that Mr. Dudley and Mr. Shanley are financially sophisticated, with substantial knowledge of and long experience in financial matters, (particularly those pertinent to investing in private investment companies), and are accordingly fully able to assess the potential risks of performance-related compensation. Superior further asserts that each of its Managing General Partners with whom Mr. Dudley and Mr. Shanley periodically consult is equally financially sophisticated, with similar knowledge and expertise, and are similarly able to asses the risk of performance-related compensation.

7. Applicants further assert that Mr. Dudley and each of Superior's Managing General Partners with whom Mr. Dudley and Mr. Shanley periodically consult have strong familial relationships with Current Greenhouse Members, Current Superior Partners, Future Greenhouse Members, and Future Superior Partners that are not qualified clients (or with the beneficiaries of the trust and custodial arrangements that are or will be such members or partners). Applicants also assert that Mr. Shanley has had a long business and social relationship with many members of the Dudley and Congdon families, and is a trustee of a number of trusts established for the Dudley family. In addition, applicants assert that Mr. Dudley, Mr. Shanley, and each of Superior's Managing General Partners with whom Mr. Dudley and Mr. Shanley periodically consult have made substantial personal investments in Applicants. Applicants assert these factors will cause Mr. Dudley, Mr. Shanley, and each of Superior's Managing General Partners with whom Mr. Dudley and Mr. Shanley periodically consult to act in the best interests of Applicants' members and partners.

8. Applicants further assert with respect to trusts and custodial arrangements that are Current Greenhouse Members and Current Superior Partners and are not qualified clients, the trustees and custodians are each qualified clients and, in many cases, are parents or other close family relations of the beneficiaries of those trusts and custodial arrangements who themselves have substantial personal investments in Applicants.

For the SEC, by the Division of Investment Management, under delegated authority.

Nancy M. Morris,

Secretary.

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[4] Under rule 205–3(d)(3), a private investment company is a company that would be defined as an investment company under section 3(a) of the Investment Company Act of 1940 but for the exception provided from that definition by section 3(c)(1) of such Act.

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–53027; File No. SR–NASD–2005–117]

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change and Amendment No. 1 Thereto Seeking Permanent Approval of Rules Concerning Bond Mutual Fund Volatility Ratings Prior to Expiration of Pilot

December 27, 2005.

I. Introduction

On September 28, 2005 and October 24, 2005 (Amendment No. 1),[1] the National Association of Securities Dealers, Inc. (''NASD'') filed with the Securities and Exchange Commission (''SEC'' or ''Commission''), pursuant to Section 19(b)(1) of the Securities

[1] Amendment No. 1 clarified the date of expiration of the pilot program concerning bond mutual fund volatility ratings.

Exchange Act of 1934 (''Act'')[2] and Rule 19b–4 thereunder,[3] a proposed rule change seeking permanent approval of NASD Rule 2210(c)(3) and Interpretive Material 2210–5 (collectively, the ''Rule'') concerning bond mutual fund volatility ratings prior to the expiration of the pilot on December 29, 2005. The Commission published the proposed rule change for comment in the **Federal Register** on November 7, 2005.[4] The Commission received one comment letter on the proposal.[5] On December 16, 2005, NASD filed a response to the comment letter.[6] This order approves the proposed rule change, as amended.

II. Description of the Proposed Rule Change

Background and Description of NASD's Rules on Bond Mutual Fund Volatility Ratings

On February 29, 2000, the SEC approved on a pilot basis NASD Interpretive Material 2210–5, which permits members and their associated persons to include bond fund volatility ratings in supplemental sales literature (mutual fund sales material that is accompanied or preceded by a fund prospectus).[7] At that time, the SEC also approved as a pilot NASD Rule 2210(c)(3), which sets forth the filing requirements and review procedures applicable to sales literature containing bond mutual fund volatility ratings. Previously, NASD staff interpreted NASD rules to prohibit the use of bond fund volatility ratings in sales material.

IM–2210–5 permits the use of bond fund volatility ratings only in supplemental sales literature and only if certain conditions are met:

- The word ''risk'' may not be used to describe the rating.
- The rating must be the most recent available and be current to the most recent calendar quarter ended prior to use.
- The rating must be based exclusively on objective, quantifiable factors.
- The entity issuing the rating must provide to investors through a toll-free telephone number or web site (or both) a detailed disclosure on its rating methodology.
- A disclosure statement containing all of the information required by the Rule must accompany the rating. The statement must include such information as the name of the entity issuing the rating, the most current rating and the date it was issued, and a description of the rating in narrative form containing certain specified disclosures.

Rule 2210(c)(3) requires members to file for approval with NASD's Advertising Regulation Department (''Department''), at least 10 days prior to use, bond mutual fund sales literature that includes or incorporates volatility ratings. If the Department requests changes to the material, the material must be withheld from publication or circulation until the requested changes have been made or the material has been re-filed and approved.

IM–2210–5 and Rule 2210(c)(3) initially were approved on an 18-month pilot basis that was scheduled to expire on August 31, 2001.[8] NASD subsequently renewed the pilot several times, most recently with a proposed rule change that was effective upon filing and extended the pilot provisions until December 29, 2005.[9]

Proposed Rule Change to Make Permanent IM–2110–5 and Rule 2210(c)(3)

As indicated in the SEC's original order approving IM–2210–5 and Rule 2210(c)(3) on a pilot basis and the NASD Notice to Members announcing such approval,[10] NASD requested the 18-month pilot period to consider whether:

- The Rule has facilitated the dissemination of useful, understandable information to investors;
- The Rule has prevented the dissemination of inappropriate or misleading information by members and associated persons;
- Additional guidance concerning the use of certain terminology may be necessary;
- The Rule should apply to in-house ratings;
- The Rule should apply to all investment companies; and
- Additional standards or guidance is needed to prevent investor confusion or minimize excessive variability among ratings of similar portfolios.

Due to the small number of bond volatility ratings filings received during the Rule's initial 18-month pilot, NASD extended the pilot to accumulate more data with which to evaluate the program. Ultimately, during the entire period from February 2000, when the Rule was first approved, until September 2005 (when NASD initially filed this proposed rule change with the Commission), NASD received a total of 47 submissions from seven NASD members. In general, the filings of sales material that contained bond fund volatility ratings have met the Rule's requirements.

Based on its findings during this period, NASD has concluded that the Rule's provisions are appropriate and do not require further amendment before being made permanent. In particular, NASD believes that the Rule has facilitated the dissemination of useful and understandable information to investors and has prevented the dissemination of inappropriate or misleading information. In this regard, virtually all of the filings NASD has received under the Rule have met the Rule's requirements, and NASD is not aware of any investor complaints concerning sales material that contains volatility ratings. The level of member compliance with the Rule also suggests that members do not require additional guidance concerning the use of certain terminology in the Rule. Similarly, NASD is not aware of any concerns that investors may be confused or that there may be excessive variability among ratings or similar portfolios.

NASD also has examined the issue of whether the Rule should apply to in-house ratings. At the time the Rule was approved, NASD observed that the Rule should not apply to in-house ratings on the grounds that they are not procured for a fee, are used primarily by fund investors as an aid in distinguishing between risk levels within a family of funds, and may be calculated using different methods from those used in calculating volatility ratings.[11] NASD continues to believe that those are persuasive reasons to not apply the Rule to in-house ratings. NASD believes that in-house ratings do not raise the same

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[2] 15 U.S.C. 78s(b)(1).

[3] 17 CFR 240.19b–4.

[4] *See* Securities Exchange Act Release No. 52709 (November 1, 2005), 70 FR 67509 (November 7, 2005) (the ''Notice'').

[5] *See* letter from Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute (''ICI'') to Jonathan G. Katz, Secretary, SEC, dated November 28, 2005 (the ''ICI Letter'').

[6] *See* letter from Joseph P. Savage, Associate Vice President, Investment Companies Regulation, NASD, to Katherine A. England, Assistant Director, Division of Market Regulation, SEC, dated December 16, 2005 (the ''NASD Response'').

[7] *See* Securities Exchange Act Release No. 42476 (February 29, 2000); 65 FR 12305 (March 8, 2000) (SR–NASD–97–89).

[8] *Id.*

[9] *See* Securities Exchange Act Release No. 52372 (Aug. 31, 2005); 70 FR 53405 (Sept. 8, 2005) (SR–NASD–2005–104); Securities Exchange Act Release No. 48353 (Aug. 15, 2003); 68 FR 50568 (Aug. 21, 2003) (SR–NASD–2003–126); NASD Notice to Members 03–48 (Aug. 2003); Securities Exchange Act Release No. 44737 (August 22, 2001); 66 FR 45350 (August 28, 2001) (SR–NASD–2001–49); NASD Notice to Members 01–58 (Sept. 2001).

[10] *See* Securities Exchange Act Release No. 42476 (February 29, 2000); 65 FR 12305 (March 8, 2000) (SR–NASD–97–89); NASD Notice to Members 00–23 (April 2000).

[11] *See* Securities Exchange Act Release No. 42476 (February 29, 2000); 65 FR 12305 (March 8, 2000) (SR–NASD–97–89).

concerns as third-party ratings, and thus do not merit application of the bond fund volatility ratings rule.

NASD also believes that it is unnecessary at this time to apply the Rule to other types of investment companies, such as unit investment trusts. At no time throughout the extended pilot period has a member requested that the Rule apply to such material, and NASD is not aware of third-party volatility ratings that are being used to assess other types of investment companies. Accordingly, NASD sees no need to expand the Rule's scope in this manner.

NASD believes that the Rule strikes an appropriate balance between the desire of some funds to advertise volatility ratings and the need to include appropriate disclosures related to those ratings in sales material. Accordingly, NASD believes that the Commission should approve the Rule, as is, on a permanent basis.

IM–2210–5(b)(2) requires supplemental sales literature that includes bond fund volatility ratings to present the most recently available rating that ''reflects information that, at a minimum, is current to the most recently completed calendar quarter ended prior to use.'' At the time IM–2210–5 was adopted, this standard mirrored the timeliness standard for mutual fund performance advertising under Rule 482 under the Securities Act of 1933. However, in 2003, the SEC amended Rule 482 to require mutual fund performance advertising to show performance that is current to the most recent calendar quarter ended prior to submission of an advertisement for publication, and to indicate where the reader may obtain performance that is current to the most recent month ended seven business days prior to use through a toll-free (or collect) telephone number or web site, or to present performance that meets this most recent month-end standard.[12]

NASD understands that rating agencies typically monitor bond funds on a monthly basis, but that it is quite rare for such agencies to revise a volatility rating on a month-to-month basis. Accordingly, NASD does not believe that it is necessary to require that volatility ratings be current as of the most recent month end given that, among other things, unlike fund performance, such ratings do not frequently change once they are issued.

[12] Rule 482(g) under the Securities Act of 1933.

III. Summary of Comments Received and NASD Response

The Commission received one comment letter from ICI on the proposal and a response to the comment letter by NASD.

The ICI Letter generally expressed reservations about the use of bond mutual fund volatility ratings in supplemental sales literature.[13] The ICI Letter also suggested that if the pilot program was approved on a permanent basis that: (i) All of the critical investor protections of the original pilot program should remain intact, (ii) the use of a single symbol, number or letter to describe a volatility rating should be prohibited and (iii) the timeliness requirements of IM–2210–5(b)(2) should be modified to mirror the requirements of Rule 482 under the Securities Act of 1933.[14]

In response to ICI's general reservations regarding the use of bond mutual fund volatility ratings the NASD Response stated that ''during the five and one-half years that the [bond mutual fund volatility rules] have been in effect, NASD has found no evidence that the use of volatility ratings in fund sales literature has harmed investors.'' [15] NASD also noted that it ''has not proposed to eliminate any of the disclosure, filing or other investor protection requirements that were contained in the original pilot rule.'' [16]

In addition, NASD expressed doubt that use of a single symbol, number or letter to describe volatility ratings harms investors, stating ''NASD fails to see how allowing the use of symbols, numbers and letters to describe a fund's volatility rating is any more harmful to investors than allowing symbols, numbers and letters to describe a fund's performance or performance ranking.'' [17]

Furthermore, NASD disagreed with ICI's recommendation to modify the timeliness requirements of IM–2210–5(b)(2).[18] NASD indicated that ''it is quite rare for [fund rating] agencies to revise a volatility rating on a month-to-month basis.'' Accordingly, NASD expressed its belief that it is not necessary ''to require that volatility ratings be current as of the most recent month end given that such ratings rarely change once they are issued.'' [19] NASD, however, cautioned its members that a ''member may not distribute supplemental sales literature containing a bond fund volatility rating if the member knows or has reason to know that the rating is false or misleading, even if the rating was current as of the most recent calendar quarter end.'' [20]

[13] ICI Letter, *supra* note 5, at 1.

[14] *Id.* at 1–2.

[15] NASD Response, *supra* note 6, at 2.

[16] *Id.*

[17] *Id.* at 3.

[18] *Id.*

[19] *Id.*

IV. Discussion and Findings

After careful review, the Commission finds that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, NASD rules 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 Commission believes that making IM–2210–5 and Rule 2210(c)(3) effective on a permanent basis will protect investors and the public interest by permitting NASD members to provide investors with useful information in a manner designed to prevent dissemination of inappropriate or misleading information.

V. Conclusions

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[21] that the proposed rule change, as amended (SR–NASD–2005–117), be, and it hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[22]

Nancy M. Morris,

Secretary.

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[20] *Id. See also* NASD Rule 2210(d)(1)(B).

[21] 15 U.S.C. 78s(b)(2).

[22] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–53026; File No. SR–NASD–2005–152]

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Extending the Pilot Relating to Manning Price-Improvement Standards for Decimals

December 27, 2005.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'') [1] and Rule 19b–4 thereunder,[2] notice is hereby given that on December 23, 2005, the National Association of Securities Dealers, Inc. (''NASD'') filed

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.