



VOICE OF THE INDEPENDENT CONTRACTOR BROKER-DEALER

February 23, 2006

VIA ELECTRONIC MAIL

Barbara Z. Sweeney  
Office of the Corporate Secretary  
NASD  
1735 K Street, NW  
Washington, DC 20006-1506

RE: Proposed Interpretive Material IM-3060 Addressing Gifts and Business Entertainment

Dear Ms. Sweeney:

The Financial Services Institute<sup>1</sup> (FSI) appreciates the opportunity to comment on NASD Notice to Members 06-06, a proposal to issue interpretive guidance concerning gifts and business entertainment. The interpretive material would supersede prior staff guidance concerning NASD Conduct Rule 3060 by more explicitly outlining the policies and procedures an NASD member firm must adopt in connection with its business entertainment practices with employees of customers.

FSI respects the NASD's concerns about the use of business entertainment to encourage employees to act in a manner inconsistent with their employer's best interests. However, FSI believes that the proposed interpretive material is overly broad, unduly burdensome, and unjustified in light of the substantial anticipated costs and limited benefits of the proposal. As a result, FSI opposes the adoption of the interpretive material.

### **Background on Institute Members**

The proposed interpretive guidance is of particular interest to FSI and its members. Our members are independent broker-dealers (IBD) and the financial advisors associated with these firms. IBDs generally clear their securities business on a fully disclosed basis; primarily engage in the sale of investment company products by "check and application"; offer primarily packaged products such as mutual funds and variable insurance products; and provide investment advisory services through either affiliated registered investment advisor firms or such firms owned by their financial advisors.

The financial advisors affiliated with these IBDs are independent contractors, rather than employees of our member broker-dealers. These financial advisors take a comprehensive, holistic approach to their clients' financial needs and objectives. They are typically located

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<sup>1</sup> The Financial Services Institute, Voice of Independent Broker-Dealers and Independent Financial Advisors, was formed on January 1, 2004. Our members are broker-dealers, often dually registered as federal investment advisors, and their independent contractor registered representatives. FSI has 97 member firms, with more than 124,000 registered representatives and over \$8.3 billion in total revenues. FSI also has more than 2,800 individual members.

in communities where they know their clients personally and provide investment advice in face-to-face meetings – often times over the client’s kitchen table. Most new clients come through referrals from existing clients or other centers of influence. Due to their close ties to the community in which they operate their small businesses, we believe these financial advisors have a strong incentive to make the achievement of their clients’ investment objectives their primary goal.

If adopted, NtM 06-06 would harm IBDs, financial advisors and their clients by consuming resources that could be used to improve customer service, develop innovative solutions to investor needs, or facilitate IBD firms’ efforts to operate more effectively and efficiently. The unfortunate result will be that the burden of these unnecessary costs will be borne by the investing public.

### **Specific Comments on Proposed Interpretive Guidance**

We have carefully reviewed and analyzed Notice to Members 06-06. In light of this careful and comprehensive review, FSI has the following comments and concerns:

#### The Proposed Interpretive Material is Overly Broad

The scope of the proposed interpretive material is overly broad. As a result, it will lead to unintended consequences that have an unjustified detrimental impact on our member firms. Specifically, the NtM’s definition of the terms “customer”, “employee”, and “business entertainment” are so broad and expansive that they prove entirely unworkable. This problem is exacerbated by a footnote to the NtM which further expands the definition of “customer.” The failure to more narrowly define these terms has a profound impact on the application of the interpretive material.

The term “customer” is defined by the proposed interpretive material as follows:

“a person that maintains, or whose employee receives business entertainment for the purpose of having such person prospectively maintain, an account with a member or is otherwise a customer of the member for the purposes of investment banking or securities business, and has an employee, agent or representative act on behalf of the account in some capacity in respect of such account or customer relationship with a member.”

This definition is flawed in several important respects. First, the definition assumes that registered representatives, and other agents of member firms, have a thorough and complete knowledge of the firm’s entire client list as well as the prospects being pursued by other representatives of the firm. Second, the definition relies upon the mistaken assumption that the intent of the member in providing entertainment will be easy to determine from the facts and circumstances. Finally, the definition is flawed in that its language fails to achieve the clarity, simplicity and accuracy necessary for member firms to develop a reasonable degree of certainty that they are properly interpreting it.

The NtM goes on to define the term “employee” to include “all persons who are employees, officers, directors, agents or representatives of a customer.”<sup>2</sup> Finally, NtM defines “business entertainment” to include “providing entertainment to an employee in the

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<sup>2</sup> NASD NtM 06-06 at page 6.

form of any social event...in which a person associated with a member accompanies and participates with such employee.”<sup>3</sup>

These definitions would appear to work together to create a number of unfortunate results. For example, it would appear possible for a representative to interact with one employee of a company for purposes other than solicitation of new business, and yet still be subject to the terms of his firm’s business entertainment policies and procedures. Another wrinkle presents itself in situations where a representative entertains an employee of a company without the intention of soliciting business from the firm. While it appears that the business entertainment rules would not apply to this situation, documenting the representative’s intentions becomes a complicated issue. Other permutations of this problem are also possible. A few examples will illustrate these points:

1. **Lack of Knowledge:** Joe Representative invites his friend Bob to be his guest for an evening of entertainment. Joe is unaware that Bob’s employer, XYZ Corp., has an account with Frank Colleague. Frank is another representative associated with Joe’s broker-dealer firm.
2. **Lack of Intent:** Joe Representative invites his friend Bob to be his guest for an evening of entertainment. During the course of the evening, he learns that Bob’s employer, XYZ Corp., may be interested in opening a brokerage account. Joe is initially interested in the prospect of landing this new account and extends the evening’s festivities to explore the opportunity further. However, he later determines that he is not interested in serving as registered representative on the XYZ account because the services required fall outside his core competencies (e.g., fixed income trading). Out of politeness to his friend, he does not directly communicate his conclusion to Bob.
3. **Lack of Clarity:** Joe Representative invites his friend Bob as his guest for an evening of entertainment. Bob is employed by XYZ Corp. Joe is unaware that Frank Colleague, another representative associated with his firm, has an evening of entertainment scheduled next week with other employees of XYZ. Frank hopes to convince XYZ to open a brokerage account with his broker-dealer.

In the first example provided above, it would appear that the registered representative is unknowingly providing business entertainment to an employee of a customer. As a result, he may be violating his firm’s policies and procedures governing business entertainment. The NtM’s definitions fail to specify that the employee who receives the benefits of the entertainment must also be the employee who acts on behalf of the employer’s account. Consequently, the NtM unintentionally sets a trap for any registered representative who fails to have a complete knowledge of his firm’s corporate client list. This is extremely unfair.

In the second example, Joe’s interest in pursuing the business of XYZ changes during the course of the evening. It would appear that these changes in his intent could impact whether or not XYZ meets the definition of “customer.” Joe may or may not be subject to his firm’s business entertainment policy. It is also unclear as to whether the policy should apply to some or all of the evening’s activity. As a result, it is likely Joe will inadvertently violate his broker-dealer’s compliance policies and procedures. Once again, this appears extremely unfair.

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<sup>3</sup> See the complete definition at page 6 of NASD NtM 06-06.

In the third example, the representative has no reason to suspect that the evening's festivities are subject to his firm's compliance policies and procedures governing business entertainment. However, it could be argued that Joe's and Bob's night out is subject to the firm's business entertainment policies by virtue of the entertainment scheduled by the other representative associated with his firm. Under the current definition, it is simply unclear what policies and procedures may apply to Joe in this situation.

These problems are further complicated by footnote 5 of the NtM. This footnote further expands the NtM's definition of "customer." This footnote reads as follows:

"Members cannot circumvent this proposed interpretive material by providing business entertainment to a natural person customer who also is an employee, agent or representative of a customer by claiming that such business entertainment applies only to the 'natural person' relationship."

This footnote effectively expands the definition of "customer" to cover all employed persons a registered representative may come in contact with, including his own family members, who are employed by companies who participate in "social events."<sup>4</sup> Once again, an example will be used to illustrate the point:

4. Joe Representative throws his father a lavish 60<sup>th</sup> birthday party. His father is employed by XYZ Corp. Joe is unaware that XYZ Corp. has a securities account with Frank Colleague, another registered representative of Joe's broker-dealer firm.

In this example, it would appear that footnote 5 may subject the entertainment provided by Joe Representative for his father's birthday to the broker-dealer's business entertainment compliance policies and procedures. This unanticipated consequence of the NtM could limit a registered representative's ability to entertain a close relative in a fashion he would normally deem appropriate. We urge the NASD to reconsider this issue.

The problems inherent in these definitions are fatal to the proper operation of the proposed interpretive guidance as those terms are basic to the understanding the NtM. The overly broad definition of "customer" results in a definition of "business entertainment" that will likely result in members requiring the reporting of all entertainment of any kind provided to any employed individual because the member could not be certain whether the individual being entertained falls within the purview of the proposed interpretive guidance. As a result, FSI believes that these definitions are overly expansive and would require NASD member firms to maintain detailed records of all business entertainment provided by their registered representatives.

#### The Proposed Interpretive Material is Unduly Burdensome

The proposed interpretive material would impose significant new burdens on NASD member firms. Specifically, members would be required to adopt written policies and procedures that:

- Determine and define forms of business entertainment that are appropriate and inappropriate

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<sup>4</sup> The proposed interpretive material defines "business entertainment" to include "providing entertainment to an employee in the form of any social event..."

- Are designed to promote conduct of the member and its associated persons that is consistent with their obligation under NASD Conduct Rule 2110
- Are designed to effectively supervise compliance with the member's written business entertainment compliance policies
- Maintain detailed records of business entertainment expenses
- Require that such records be made available to a customer in respect to that customer's employees
- Establish standards to ensure that persons designated to supervise the business entertainment expenses are sufficiently qualified
- Ensure that periodic monitoring of compliance with the written policies is conducted (by an independent reviewer, when practicable), and
- Require training and education for all appropriate personnel.

The interpretive material directs firms to adopt business entertainment policies and procedures that will prevent doing or giving “anything of value to the employee that is intended or designed to cause, or otherwise would be reasonably judged to have the likely effect of causing, such employee to act in a manner that is inconsistent with the best interests of the customer.”<sup>5</sup> Unfortunately, as was demonstrated above, the proposed interpretive material's definitions of “customer”, “employee” and “business entertainment” are extremely broad. In practical application, they will result in NASD member firms requiring extensive documentation of all entertainment their employees and representatives engage in. This documentation will be required to either demonstrate compliance with the firm's policies and procedures or to document that the entertainment falls outside of the parameters. In either case, the documentation generated will likely be significant.

In light of the challenges posed by the interpretive material, the supervision and record keeping requirements adopted by member firms are likely to be extensive, if not overwhelming. The costs associated with the design, implementation, administration and monitoring of these compliance policies and procedures will be enormous. The resulting burden on NASD member firms is simply unreasonable.

#### The Proposed Interpretive Material is Unjustified in Light of Anticipated Costs and Benefits

FSI believes that regulatory requirements that require the adoption of costly policies and procedures must be rigorously supported by the information, analysis, and assumptions that underpin them. When the NASD fails to provide this background, it deprives member firms of the information necessary to offer thoughtful comments to the proposal. The result is the NASD is unnecessarily deprived of the best thinking its members have to offer.

Unfortunately, in NtM 06-06 the NASD offers no specific empirical data to explain its reason for proposing the interpretive material at this time. Instead, the NtM simply states that the interpretive material is necessary “in light of recent events.”<sup>6</sup> No further explanation is provided. NASD member firms are left to guess at the reasons for the NASD's proposal. There is no apparent reason for this lack of specificity.

Nevertheless, common sense would lead to the consideration of at least two plausible motives: (1) NASD member firms have requested clarification of the requirements of

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<sup>5</sup> NASD NtM 06-06 at page 6.

<sup>6</sup> NASD NtM 06-06 at page 2.

NASD Conduct Rule 3060 with sufficient frequency to indicate widespread confusion, or (2) Violations of the NASD Conduct Rule 3060 have been prevalent in enforcement actions, on-site inspections, or other NASD investigations of member firms. However, a review of the NASD's web site fails to support either of these theories.

In 1999, the NASD's staff clarified that Rule 3060 does not prohibit "ordinary and usual business entertainment" provided that the entertainment is "neither so frequent nor so extensive as to raise any question of propriety."<sup>7</sup> Since that time, the NASD has received only one additional written request for clarification of the applicability of Rule 3060.<sup>8</sup> As a result, the evidence does not appear to support the conclusion that NASD member firms are in need of clarification of Rule 3060 and its application to business entertainment.

Similarly, a search of the NASD's web site for recent enforcement actions and/or customer complaints involving violations of NASD Conduct Rule 3060 failed to deliver the anticipated flood of regulatory activity. Instead, a single enforcement action was found.<sup>9</sup> It would appear that violations of the current Rule are rare. It is, therefore, difficult to understand what "recent events" have led to the proposal of this new interpretive material. It is also difficult to imagine what benefits are anticipated from its adoption. In light of the substantial costs and the limited nature of the anticipated benefits, there is no justification for adoption of the interpretive material.

It is important to note that the use of gifts and business entertainment in order to curry the favor of influential employees of an important customer, or prospect, is hardly unique to the securities business. Business owners have been dealing with these concerns for years. In fact, many companies have developed their own policies and procedures to insure that business decisions are made in furtherance of the company's objectives – not the objectives of a single employee. As a result, FSI believes the customer's own enlightened self-interest is likely to serve as the most effective regulator of gifts and business entertainment.

## **Conclusion**

In summary, FSI believes that the interpretive material proposed by this NtM is unworkable because it is overly broad, unduly burdensome and without justification. FSI strongly urges the NASD to maintain the status quo by allowing the staff interpretation that has guided member's use of business entertainment since 1999 to remain in place. However, if the NASD believes that further clarification of NASD Conduct Rule 3060 is necessary, we would strongly urge the use of the traditional rule making process. The deliberative nature of this process allows the time for the thoughts and experience of a greater number of industry participants to influence the quality of the final regulation.

We appreciate the opportunity to share the views of our members with the NASD on NtM 06-06. Please feel free to contact me at 770 980-8487 with any questions or to discuss further any of our comments.

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<sup>7</sup> Letter to Henry H. Hopkins and Sarah McCafferty, T. Rowe Price Investment Services, Inc., from R. Clark Hooper, NASD, dated June 10, 1999.

<sup>8</sup> Letter to Charles Weigert, NFP Securities, from Sarah J. Williams, NASD, dated March 15, 2001.

<sup>9</sup> Searches of the NASD web site were performed using the search terms "3060 enforcement" and "3060 violation." These searches retrieved only one relevant reference, an Acceptance Waiver and Consent entered into by Nalico Equity Corporation (CRD #15530, Giessen, Germany) in July of 2005 (NASD Case # C3A050032).

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Dale Brown". The signature is fluid and cursive, with the first name "Dale" and last name "Brown" clearly distinguishable.

Dale E. Brown, CAE  
Executive Director & CEO

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