



**NASD REPORT ON EXAMINATION FINDINGS
REGARDING GIFTS AND GRATUITIES**

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Introduction

As a result of a recent review of gift and gratuity practices of over 40 member firms, NASD staff is concerned that members may not be fulfilling their obligations to comply with, and establish adequate supervisory systems and procedures reasonably designed to achieve compliance with, NASD's rule governing gifts and gratuities – Conduct Rule 3060 (the “gift rule”).¹ Rule 3060 prohibits any member or person associated with a member from giving, or permitting to be given, anything of value in excess of \$100 per individual per year where such payment is in relation to the business of the recipient's employer.² Rule 3060 also requires members to retain a separate record of all payments or gratuities.³ Rule 3010 requires firms to have systems and procedures reasonably designed to achieve compliance with NASD Rules, including Rule 3060.

This report details our findings from a review of more than 40 member firms with respect to compliance with the gift rule over a two-year period, and the supervision of firm practices in this area. In light of the findings from this examination, NASD is also issuing Notice to Members 06-69, which provides additional guidance with respect to compliance with Rule 3060.

¹ The NASD gift rule has been in effect, in one version or another, since 1937. In 1969, in the first and most substantive amendment, the rule (renumbered from Section 10 to Section 10(a)) was modified to a form identical to current Rule 3060(a), except that the dollar limitation, currently \$100, was then \$25.

² Rule 3060(a) states:

No member or person associated with a member shall directly or indirectly, give or permit to be given anything of value, including gratuities, in excess of one hundred dollars per individual per year to any person, principal, proprietor, employee, agent or representative of another person where such payment or gratuity is in relation to the business of the employer of the recipient of the payment or gratuity. A gift of any kind is considered a gratuity.

³ Rule 3060(c) states:

A separate record of all payments or gratuities in any amount known to the member...shall be retained by the member for the period specified by SEC Rule 17a-4.

Background

During a routine examination of a member firm in 2004, NASD Member Regulation staff noted a number of gifts and expensive entertainment conferred by certain registered representatives upon employees of a large investment advisory firm. Shortly thereafter, a series of press reports revealed that certain NASD member firms may not be complying with Rule 3060, both with respect to the giving of violative gifts and the conferral of inappropriate business entertainment,⁴ and Rule 3010, which requires member firms to have adequate systems and procedures to ensure compliance with Rule 3060. Many of these press reports described lavish entertainment events and significant gifts being bestowed on employees of institutional customers of NASD member firms, including employees of investment advisors.⁵

In late 2004, NASD requested information from over 40 firms engaged in institutional sales and trading in an effort to assess NASD member firm compliance with Rule 3060, and the adequacy of member firms' systems and procedures to achieve compliance with the Rule. The firms included in the staff's review ranged in size from fewer than 20 to over 24,000 registered representatives and included local, regional, national and multinational broker-dealers. Information requested included (i) a listing of gifts and entertainment provided by the member firms; and (ii) policies and procedures in place to ensure compliance with Rule 3060.

NASD's Departments of Enforcement and Member Regulation have prepared and published this Report in an effort to inform both the securities industry and the investing public of certain findings and observations we have made in connection with this review. Our review included an analysis of potential violations of the gift rule and the systems and procedures used to ensure compliance with the gift rule. We believe the findings from this review reinforce the validity of the new approach to business entertainment described in proposed IM-3060.

⁴ See NASD Interpretative Letter, dated June 10, 1999, stating that Rule 3060 does not limit ordinary and usual business entertainment such as an occasional meal, sporting event, theater production or comparable entertainment event . . . so long as it is neither so frequent nor so extensive as to raise any question of propriety.

⁵ See, e.g., Jenny Anderson, *Fidelity Disciplines 16 Traders Over Gifts From Brokers*, N.Y. Times, Dec. 17, 2004, at C5; Andrew Caffrey & Jeffrey Krasner, *Probe of Gifts Said to Focus on Fidelity*, Boston Globe, Dec. 7, 2004, at A1; *Probe on Gifts to Fund Officials Is Said to Include Jeffries*, Los Angeles Times, Dec. 3, 2004, at C4; Jenny Anderson, *On Wall Street, A Closer Look at Giving Gifts*, N.Y. Times, Nov. 24, 2004, at C1; Greg Farrell, *Brokerages' Gifts to Mutual Fund Managers Scrutinized*, USA Today, Nov. 24, 2004, at B2.

NASD Staff Findings

A. Problematic Data Produced by Member Firms

1. **Information Requested:** NASD requested that each firm provide a schedule of instances in which the firm or an associated person of the firm conferred a gift, gratuity, travel or entertainment (each, a benefit) to an employee of another firm. As set forth in the request letter, each firm was required to provide specific information for each entry, including:

- recipient name(s);
- value or cost of the benefit;
- description of the benefit;
- date the benefit was conferred;
- employer of recipient;
- whether the benefit constituted a gift, gratuity, travel or entertainment; and
- for each entertainment benefit, whether the client was accompanied by an associated person of the firm, and, if so, the identity of such person.

NASD Rule 3060(c) requires each member to retain a separate record of all payments or gratuities in any amount known to the member for the period set forth in SEC Rule 17a-4.

2. **Lack of Centralized Record-keeping Systems:** Most firms were not able to promptly comply with the staff's request due to the fact that the requested information was not easily accessible in the firms' records. Many firms relied on their travel and expense (T&E) reimbursement systems as the most accessible, centralized record-keeping system for gifts, gratuities, travel and entertainment. Yet these systems were not designed to assess compliance with the requirements of Rule 3060. In addition, at least two firms did not maintain the requested information in electronic form and relied solely on paper T&E records. Finally, most firms did not consolidate gift, gratuity, travel and entertainment information from the T&E systems with information from the firms' general ledger systems. Responses to our request were often substantially delayed, in large part because information about gifts and entertainment was located in several different systems and responding to NASD's request required a piecemeal production with varying degrees of detail produced, depending on the source of the record used.

3. Other Weaknesses of Gift and Gratuity Data Produced: In general, we found that firms did not maintain adequate records of gifts, gratuities, travel and entertainment, nor were such records maintained on a per recipient basis. Rather, expenses for gifts for multiple recipients were frequently combined into single line items and in many cases gift expenses were intermingled with entertainment expenses. While it is possible that the underlying hand-written expense reports would have reflected this information, the information was not easily accessible or maintained at the firms in a centralized manner. Furthermore, the manner in which gift and entertainment information was maintained did not enable aggregation of gifts or analysis of gifts and entertainment received by individual recipients over time.

As a result of these record-keeping weaknesses, it was difficult to determine whether individual gifts were valued at under \$100, and the lack of information on a per recipient basis rendered it extremely difficult to aggregate gifts to the same recipient over the course of each year to evaluate compliance with Rule 3060. Similarly, the staff encountered difficulties in aggregating expenditures for travel and entertainment to assess the collective benefits conferred upon recipients over time. These record-keeping weaknesses highlighted the inadequacy of the firms' supervisory systems, since it was impossible to adequately monitor and detect potential violations of the gift rule.

With regard to entertainment, and event tickets in particular, most firms did not maintain adequate records as to whether an associated person of the firm attended the event with the client. At most firms, employees were able to purchase tickets and later seek reimbursement, or request tickets previously purchased by the firm. With respect to firm-purchased tickets, employees generally were required to identify prospective guests before receiving tickets; however, at virtually all of the firms, employees were not required to create records of the individuals who actually attended the event. For reimbursed tickets, while many firms had systems that had the ability to collect attendee information, most firms did not require brokers to provide this information to obtain reimbursement, nor did most firms require brokers to indicate whether or not they attended events with clients. Although many firms spent hundreds of thousands of dollars, and in some cases millions of dollars, per year on event tickets, most firms did not have a system to adequately record when an associated person attended an event with a client. In some cases, firms did not keep consistent records of even which associated persons received the tickets. As a result, the firms were unable to assess which tickets were given as gifts to clients, which were used for client entertainment, and which were used for another purpose, such as an employee-only event.

The staff requested additional documentary information from the firms regarding certain large gifts and very costly entertainment events. The staff also requested information in certain instances where attendee information was not provided, to determine whether an associated person attended the event

(thereby rendering the event business entertainment), or whether the event was attended solely by the client (in which case it would be deemed a gift). Although the firms generally were able to provide the requested information after considerable research efforts, such as retrieving off-site paper documents and interviewing brokers, it was clear that records of the information sought by NASD, the bare minimum to evaluate compliance with Rule 3060, were often not adequately maintained by firms.

B. Record-Keeping Deficiencies Observed

As described above, most firms did not have an adequate system of record-keeping to enable reliable monitoring and detection of Rule 3060 violations. In general, the most common record-keeping system deficiencies consisted of failures to:

- maintain records of gifts and entertainment aggregated by individual recipient;
- require brokers to provide complete attendee information, including whether the broker attended, for all ticketed events; and
- maintain a firm-wide, centralized record-keeping system for all gifts and entertainment capable of aggregating gifts and entertainment by recipient on an annualized basis.

The record-keeping deficiencies observed by the staff not only failed to satisfy the requirements of Rule 3060(c), but failed to serve as the basis for adequate supervision. Without a centralized system to gather and compile information on the benefits conferred to clients on a per recipient basis, it is not possible to adequately monitor and detect potential violations of the gift rule.

C. Findings Regarding Systems and Procedures to Achieve Rule 3060 Compliance

In addition to requesting data, NASD required each firm reviewed to produce a copy of its written supervisory procedures regarding Rule 3060 and describe the manner in which it supervised and enforced its procedures.

1. Systems and Procedures for Gifts: We found that most of the firms we reviewed had a written supervisory procedure that incorporated at least the basic restriction of Rule 3060 – i.e., a written procedure that prohibited representatives from conferring gifts in excess of \$100 per year to clients. Many firms also periodically communicated this \$100 gift restriction through written memoranda or broadcast email messages, particularly during the holiday season, and reminded associated persons of their policies at annual compliance meetings.

Most firms also required supervisory approval of all T&E reports, which included reimbursement requests for gifts. Firms generally did not have a separate approval process for gifts and the focus of these controls appeared to be on cost management rather than achieving compliance with Rule 3060. For example, very few firms required pre-approval of gifts. Rather, firms focused their supervisory approval process on obtaining sufficient information after a gift had already been given to determine whether a gift was reimbursable under the firm's T&E policies, similar to any other travel and expense reimbursement. While most firms required supervisors to approve T&E reports prior to reimbursing a broker for an out-of-pocket expense, in many cases supervisors did not require brokers to provide complete recipient information before approving gifts. Similarly, the electronic systems used by most firms to gather gift information did not have "forced fields" or other safeguards in place to ensure that all pertinent information regarding a gift was collected prior to processing the approval of a gift.

In addition, most firms reviewed did not have a system or procedures to aggregate gifts by recipient on an annual basis to ensure that no client received more than \$100 of gifts per year. In summary, although most firms had a written supervisory procedure that prohibited giving gifts in excess of \$100 per year, and communicated this to their employees, nearly all firms lacked a system to ensure that the information necessary to evaluate whether a gift was violative was collected, and furthermore lacked a system to aggregate gifts to recipients to evaluate compliance with the gift rule.

2. Systems and Procedures for Entertainment: In general, the firms reviewed did not have procedures reasonably designed to ascertain whether entertainment was appropriate and consistent with the rule and applicable state and federal laws. While most firms required supervisory approval for an employee to obtain reimbursement for business entertainment expenses, again through the T&E reimbursement system, as with gifts, the approval process appeared to focus primarily upon controlling costs rather than preventing employees from conferring entertainment that would potentially have the effect of causing an employee of a client to act in a manner inconsistent with the best interests of his employer. Most firms also failed to articulate through written procedures, or otherwise, clear standards as to the types and levels of entertainment that were acceptable.

For most firms, the reimbursement and approval process for entertainment expenses mirrored the process used for gifts. Employees were asked to enter information into the T&E reimbursement system, including attendee names and the details of the entertainment, but attendee names and attendee employer information were frequently omitted by brokers seeking reimbursement. In many cases, these omissions did not prevent the T&E systems' acceptance of the event information, nor did the missing information prevent supervisory approval

of the expense. Similarly, while not every firm reviewed used chartered aircraft to provide travel to clients, those firms that did provide transportation to clients on private aircraft lacked adequate systems and procedures to ensure that such travel was appropriate under the circumstances, and that accurate records of attendees were maintained and reviewed for compliance with the gift rule. In addition, most firms did not have a system to track entertainment expenditures by clients, nor did firms otherwise seem to monitor whether employees of institutional clients were receiving entertainment at levels that might cause them to act in a manner inconsistent with the best interests of their employers.

3. Systems and Procedures for Tickets: As discussed above, when a firm provides a ticket to a client and an associated person does not attend the event with the client, the ticket is deemed a gift (rather than business entertainment) and therefore counts toward the \$100 limit of the gift rule. NASD staff found that the member firms reviewed purchased thousands to millions of dollars in tickets to sporting events, concerts, and other forms of entertainment each year, yet very few firms had adequate controls in place to monitor the manner in which these tickets were used and to whom they were given.

As noted, employees were able to procure event tickets in two ways. In some firms, employees were permitted to purchase tickets through ticket brokers and later seek reimbursement by submitting an itemized expense report (T&E) to the firm. Typically, these expense reports would include some attendee information, though firms in general did not diligently enforce complete and accurate reporting of this information before honoring reimbursement requests from employees. Most firms also purchased tickets at the corporate level and made them available to employees for the purpose of entertaining clients. While some firms had formal processes for employees to request these “bulk” tickets, many firms did not require employees to provide complete attendee information before distributing tickets to employees. In many cases, firms did not create or maintain centralized records as to whether tickets were used for client entertainment or employee-only events.

While some of the firms reviewed provided written guidance to their associated persons that employee attendance at ticketed events was necessary to prevent a ticket from becoming a gift, a significant number of firms did not provide this guidance to their employees. While some firms required employees to list prospective attendees before giving bulk tickets to employees, virtually all firms failed to verify, after an event occurred, that an associated person of the firm attended the event and failed to ensure that client attendee lists were updated reflect actual (rather than projected) attendees.

Thus, firms did not sufficiently monitor whether tickets were used as gifts or keep adequate records of those instances in which tickets were used as gifts. In connection with NASD’s request, firms engaged in a self-assessment process to research the extent to which tickets had been used as gifts. One firm sampled

approximately 250 ticketed events and, through interviews with the associated persons involved, concluded that in 50 instances an employee of the firm did not attend and therefore the tickets should have been recorded as gifts.

Another firm submitted data to NASD in which approximately half of the ticket entries did not include client or employee attendee information. When NASD followed up with the firm, we learned that the firm had incomplete records of attendees for most of its season tickets. In many cases, attendee information included clients but did not include employees of the firms. When the staff requested supplemental employee attendance information from some firms, the response to NASD was that employees were expected to attend events with clients and therefore it was assumed that an employee of the firm had attended in all cases.

D. Gift Findings

During its review, the staff identified a number of gifts that were violative of Rule 3060 because (i) the individual gift was over \$100, or (ii) the recipient received over \$100 in gifts over the course of one year. Generally, however, the vast majority of gifts given by firms either did not exceed the \$100 limit, or exceeded it by only a de minimis amount, and were limited to the following broad categories:

- Holiday Gifts: Gift baskets, wine, and miscellaneous gifts given to clients close in time to the December holidays;
- Gifts Incident to Entertainment: Golf-related gifts, such as clothing or equipment purchased at a pro shop, possibly in connection with client outings, and items purchased at professional sports events;
- Ticket Gifts: Event tickets given as gifts where the broker did not attend the event; and
- Closing Gifts: Gifts given in connection with the culmination of a business transaction, such as lucite tombstones.

E. Proposed IM-3060

In January 2006, NASD issued for comment proposed interpretive material (IM) to Rule 3060 to more explicitly outline the policies and procedures a member must adopt in connection with its business entertainment practices with employees of a customer.⁶ The proposed IM would expand on and supersede

⁶ On April 11, 2006, NASD filed IM-3060 with the SEC; See File No. SR-2006-044 (April 11, 2006).

prior staff guidance in this area, including without limitation the 1999 Interpretive Letter, and provide a principles-based approach to business entertainment.

Whereas the 1999 NASD Interpretive Letter guided members to evaluate whether business entertainment was “ordinary and usual,” based on the criteria of frequency and extensiveness, the proposed IM takes a different approach. First, the IM makes it clear that Rule 3060 applies only to entertainment given to employees, agents or representatives of a customer (such as employees of an institution) and not to a natural person customer (such as an individual retail customer). Second, the proposed IM defines the term “business entertainment” to clarify NASD’s longstanding views that a member must attend an event with the customer for the event to be deemed business entertainment, and that transportation and lodging expenses provided by a member in connection with an event are properly deemed part of the business entertainment.⁷

Under the proposed IM, a member should not do or give anything of value to an employee of a customer 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. Members must have written policies and procedures that:

- determine and define forms of business entertainment that are appropriate and inappropriate, including the appropriate venues, nature, frequency, types and class of accommodation and transportation in connection with business entertainment, and either the dollar amounts of business entertainment or specified dollar thresholds requiring advance written supervisory approval;
- are designed to promote conduct of the member and its associated persons that is consistent with their obligations under Rule 2110 and does not undermine the performance of an employee’s duty to a customer;
- are designed to effectively supervise compliance with a member’s written compliance policies and procedures concerning business entertainment;
- are designed to maintain detailed records of the nature and expense of any business entertainment in excess of \$50 and make such information available upon written request to a customer in respect of its employees;
- establish standards to ensure that persons designated to supervise, approve and document business entertainment expenses are sufficiently qualified and that periodic monitoring for compliance with the written policies and procedures is conducted (by an independent reviewer, when practicable); and

⁷ Id. at 13.

- require appropriate training and education to all applicable personnel.⁸

The proposed IM also provides additional guidance to assist firms in developing standards of acceptable forms of business entertainment, noting that “the guiding principle in navigating the concern of placing an employee in conflict with his duty to a customer is that members should compete for business on the basis of providing the best professional services.”⁹

F. Overall Findings

This review revealed that many firms have not instituted reasonably designed systems and procedures to achieve compliance with the gift rule. Firms are not adequately reviewing for compliance with the \$100 limit on an aggregated basis, and firms’ systems are not adequate to ensure that all pertinent information necessary to monitor and enforce compliance with Rule 3060 is collected and kept in a centralized, easily accessible manner.

It also appears that many firms have focused their supervision of gifts and entertainment on cost control rather than gift rule compliance. Moreover, firms are not consistently identifying all recipients of gifts and entertainment and assessing in the ordinary course of business whether such activities (i) are consistent with regulatory requirements, (ii) create the potential for conflicts of interest, or (iii) are otherwise not in conformity with firms’ own policies and procedures. In light of the findings from this examination, NASD has issued Notice to Members 06-69, which provides additional guidance with respect to compliance with Rule 3060.

Conclusion

While the observations and findings described herein have not, to date, been reflected in formal disciplinary actions, the issues presented may be the subject of future disciplinary actions, and we believe they serve as useful guidance akin to both best practices and business practices to be avoided in connection with this subject matter. NASD considers it essential that firms comply with the gift rule to avoid the improprieties that can result from excessive gifts and entertainment conferred to employees of institutional clients. Firms must increase their vigilance in this area to detect and prevent potential violations. To accomplish this goal, firms must revisit their systems and procedures for achieving compliance with Rule 3060 and identify deficiencies that may currently exist. Proposed IM-3060, together with the guidance provided

⁸ Id. at 6.

⁹ Id. at 8. See also Notice to Members 06-21 (May 2006) providing guidance on charitable contributions.

Notice to Members 06-69, are valuable resources to approach this endeavor and members are expected to take appropriate remedial action to correct any deficiencies in their systems and procedures that may currently exist.