

Notice to Members

JANUARY 2006

SUGGESTED ROUTING

Internal Audit
Institutional
Legal and Compliance
Retail
Senior Management
Training

KEY TOPICS

Business Entertainment
Commercial Bribery
Gifts and Gratuities
Rule 3060

REQUEST FOR COMMENT

Gifts and Business Entertainment

NASD Requests Comment on Proposed Interpretive Material IM-3060 Addressing Gifts and Business Entertainment; **Comment Period Expires February 23, 2006**

Executive Summary

NASD is proposing interpretive material (IM) to Rule 3060 (Influencing or Rewarding Employees of Others) to more explicitly outline the policies and procedures a member must adopt in connection with its business entertainment practices with employees of a customer. The proposed IM would expand on and supersede prior staff guidance in this area.

Action Requested

NASD encourages all interested parties to comment on this proposal. Comments must be received by **February, 23, 2006**. Members and interested persons can submit their comments using the following methods:

- ▶ Mail comments in hard copy to the address on the address below; or
- ▶ Email written comments to pubcom@nasd.com.

To help NASD process and review comments more efficiently, persons commenting on this proposal should use only one method. Comments sent by hard copy should be mailed to:

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

06-06

Important Notes: The only comments that will be considered are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the NASD Web site. Generally, comments will be posted on the NASD Web site one week after the end of the comment period.¹

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the NASD Board, and then must be approved by the SEC, following publication for public comment in the *Federal Register*.²

Questions/Further Information

As noted above, hard copy comments should be mailed to Barbara Z. Sweeney. Questions regarding this *Notice* may be directed to Gary L. Goldsholle, Associate Vice President and Associate General Counsel, Office of General Counsel, NASD Regulatory Policy and Oversight, at (202) 728-8104.

Background and Discussion

Rule 3060 prohibits any member or person associated with a member, directly or indirectly, from giving anything of value in excess of \$100 per year to any person where such payment is in relation to the business of the recipient's employer. The rule protects against improprieties that may arise when members or their associated persons give gifts or gratuities to employees of a customer.

In response to an interpretive request, the staff in 1999 issued a letter stating that Rule 3060 does not prohibit "ordinary and usual business entertainment" (such as an occasional meal, sporting event, theater production or comparable entertainment event) provided that such entertainment is "neither so frequent nor so extensive as to raise any question of propriety."³ This interpretive position was based in part upon NASD's rules governing non-cash compensation in connection with the offer and sale of investment company shares and variable annuities.⁴

In light of recent events, NASD has proposed an IM to Rule 3060 to more explicitly outline the policies and procedures that a member must adopt in connection with its business entertainment practices. The proposed IM (set forth in Attachment A) would supersede any prior guidance, including the 1999 Letter.

The Proposed IM

The proposed IM defines the terms “customer” and “business entertainment.” For purposes of IM-3060, a “customer” is 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 purpose 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 the member.” This definition recognizes the proposed distinction between business entertainment provided directly to natural person customers (which is not covered by Rule 3060) and business entertainment provided to employees, agents or representatives of a customer (which is covered by Rule 3060).⁵

The proposed IM also defines the term “business entertainment” as entertainment “in the form of any social event, hospitality event, charitable event, sporting event, entertainment event, meal, leisure activity or event of like nature or purpose, as well as any transportation and/or lodging accompanying or related to such activity or event, including such business entertainment offered in connection with an educational event or business conference, in which a person associated with a member accompanies and participates with such employee irrespective of whether any business is conducted during, or is considered attendant to, such event.” This definition codifies NASD’s longstanding position that a member must accompany or participate in an event for it to be deemed business entertainment. Thus, for example, if a member gives tickets to a sporting event but does not accompany the recipient to the event, the tickets are deemed to be a gift rather than business entertainment. In addition, the definition of “business entertainment” expressly includes transportation and lodging expenses provided by a member.

The overriding principle of the proposed IM is that a member or its associated persons 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. The proposed IM provides guidance concerning the written policies and procedures that members must adopt surrounding their business entertainment practices. First, the member must determine and define the forms of business entertainment that are appropriate and inappropriate, including appropriate venues, nature, frequency, types and class of accommodation and transportation, and either firm dollar limits or thresholds requiring advance written approval. Notably, the proposed IM does not impose hard limits, nor does it require that all members adopt the same limits or even treat all recipients equally. At the same time, however, a member’s policies and procedures must not be so unbounded or vague that no reasonable determination of propriety can be discerned. In addition, the proposed IM expressly would allow members to set different standards for business entertainment in connection with events that are educational, charitable or philanthropic in nature.

Second, the member's written policies and procedures must promote conduct consistent with Rule 2110 and should not undermine the performance of an employee's duty to a customer. A member's policies and procedures should preclude providing business entertainment that is so lavish or extensive in nature that an employee would likely feel compelled to act in a manner inconsistent with the interests of his or her employer (such as directing order flow without due regard to best execution or other transaction pricing considerations).

Third, the written policies and procedures must provide for effective supervision and compliance with a member's business entertainment policies. Members are free to define the approach and method of their written policies and procedures provided they are reasonably designed to comport with the principles stated in the proposed IM. Irrespective of the manner in which a member crafts its procedures, however, it must be clear from the supervisory policies and procedures those factors that determine appropriate levels of business entertainment and how those determinations are executed, monitored and enforced. Moreover, the supervisory procedures should provide a method for evidencing both the breadth of supervisory activities as well as the information upon which such supervision is conducted.

Fourth, members must maintain detailed records of business entertainment expenses and make such information available to the customer in respect of its employees upon written request. This would allow a customer to verify and review the types of business entertainment received by its employees, which may serve as additional protection against awarding business entertainment that causes, or has the likely effect of causing the recipient to act in a manner that is inconsistent with the best interests of his or her employer.

Fifth, the member must 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. While the proposed IM does not require an independent review in all cases, as a general matter, firms should, where practicable, establish procedures to have periodic monitoring of business entertainment by an independent reviewer. And sixth, members should oversee the training and education of all personnel concerning the firm's business entertainment policies and procedures.

Finally, the proposed IM expressly states that firms may not offer anything of value, including, but not limited to, business entertainment, which comprises conduct that is illegal under any applicable law or would expose the member, customer or recipient to any civil liability to any governmental authority or agency.

Endnotes

- 1 See *Notice to Members 03-73* (November 2003) (NASD Announces Online Availability of Comments). Personal identifying information, such as names or email addresses, will not be edited from submissions. Submit only information that you wish to make publicly available.
- 2 Section 19 of the Securities Exchange Act of 1934 (Exchange Act) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily abrogate these types of rule changes within 60 days of filing. See Exchange Act Section 19 and rules thereunder.
- 3 Letter to Henry H. Hopkins and Sarah McCafferty, T. Rowe Price Investment Services, Inc., from R. Clark Hooper, NASD, dated June 10, 1999 (1999 Letter).
- 4 See Rules 2820(g)(4)(B) and 2830(l)(5)(B).
- 5 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.

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ATTACHMENT A

Proposed IM Text

IM-3060. Entertainment of the Employees of Persons who are Customers of a Member

The NASD Board of Governors is issuing this interpretation concerning the obligations of a member in connection with any entertainment of the employees of a person who is a customer of the member. This interpretation supersedes any prior interpretive letters or statements of NASD staff on this matter.

For the purpose of this interpretation the following terms are defined:

The term "customer" means 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 the member. The term "employee(s)" means all persons who are employees, officers, directors, agents or representatives of a customer.

The term "business entertainment" means providing entertainment to an employee in the form of any social event, hospitality event, charitable event, sporting event, entertainment event, meal, leisure activity or event of like nature or purpose, as well as any transportation and/or lodging accompanying or related to such activity or event, including such business entertainment offered in connection with an educational event or business conference, in which a person associated with a member accompanies and participates with such employee irrespective of whether any business is conducted during, or is considered attendant to, such event. Any thing of value given to an employee that is not defined as entertainment is a gift under Rule 3060.

The observance of the "high standards of commercial honor and just and equitable principles of trade" required of a member in the conduct of its business under Rule 2110 includes the obligation of a member not to act in a manner contrary to the best interests of a customer in the conduct of business with or for such customer. Consequently, when a member interacts with an employee of a customer, the member should not do or give 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.

Rule 2110 precludes the offering of any thing of value, including but not limited to business entertainment, which comprises conduct, that to any degree, is either illegal under any applicable law or would expose the member, customer or recipient of the member's entertainment to any civil liability to any governmental authority or agency. For example, any business entertainment that violates the Foreign Corrupt Practices Act, or any commercial bribery statutes and laws, or would subject the member or employee (or customer by reason of respondeat superior) to any civil penalties to any governmental authority or agency because of the entertainment, in turn violates Rule 2110 and this interpretation.

Written Policies and Procedures

Members must have written policies and procedures that:

- (1) 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;
- (2) 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;
- (3) are designed to effectively supervise compliance with a member's written compliance policies and procedures concerning business entertainment;
- (4) maintain detailed records of the nature and expense of business entertainment and make such information available upon written request to a customer in respect of its employees;
- (5) 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
- (6) require appropriate training and education to all applicable personnel.

Members may distinguish, and set specifically tailored standards for, business entertainment in connection with events that are educational, charitable or philanthropic in nature. If such differentiation is made, it must be explicitly addressed in the written policies and procedures with specifically tailored standards. Finally, a member must be able to demonstrate that it trains its associated persons who supervise and are subject to such written business entertainment policies and procedures in all applicable requirements.

Acceptable Forms of Business Entertainment

A member may determine that certain activities, though legal, are nevertheless inappropriate for business entertainment. Similarly, members may determine that certain modes of private transport, luxurious accommodations, or destinations are not appropriate either as a matter of course or unless certain circumstances are present and senior management has approved the business entertainment.

The Board of Governors believes that the standards of entertainment adopted by members must meet the requirement under Rule 2110 that members and employees adhere to high standards of commercial honor. Consequently, a member would violate this interpretation and the rule, not only if it failed to adopt such procedures, but also if the procedures set standards that are so unbounded or vague that no reasonable determination of propriety can be discerned.

A member's written policies and procedures must also be reasonably designed to achieve compliance with the obligation of the member and its associated persons to act in the best interests of its customer in connection with the conduct of business with or for such customer, including the avoidance of any business entertainment of an 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. As an example, members should develop written policies and procedures reasonably designed to preclude providing business entertainment that is so lavish or extensive in nature that an employee would likely feel compelled to place order flow on behalf of the customer without due regard to best execution or other transaction pricing considerations. In sum, the Board of Governors believes 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. While it is not inappropriate for business entertainment to foster an environment for the member to promote or educate with respect to such professional services, it is inconsistent with the terms of this interpretation to use business entertainment to provide incentives to employees to conduct customer business with and/or through the member without due consideration as to whether the nature and terms of such professional services meet the objectives and are in the best interests of the account.

Supervision

As is the case with every NASD rule, supervision is a critical component of entertainment policies and procedures. Members are free to define the approach and method of their written policies and procedures provided they are reasonably designed to comport with the principles stated in this interpretation. Irrespective of the manner in which the members craft their procedures, it must be clear from the supervisory policies and procedures what factors determine appropriate levels of business entertainment and how those determinations are executed, monitored, and enforced. In addition, such supervisory procedures should provide a method for evidencing both the breadth of supervisory activities as well as the information upon which such supervision is conducted. For example, a member's policies and procedures must evidence the basis upon which a supervisor will determine that business entertainment does not violate a member's standards as to the nature, frequency and dollar amounts of entertainment. Finally, the member must review periodically the policies and procedures it establishes to determine if they are practicable and fulfill their purpose.