

OMB APPROVAL

OMB Number: 3235-0045
Expires: June 30, 2007
Estimated average burden
hours per response.....38

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
Form 19b-4

File No. SR - 2006 - 044

Amendment No.

Proposed Rule Change by National Association of Securities Dealers

Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

Initial ☒ Amendment ☐ Withdrawal ☐

Section 19(b)(2) ☒Section 19(b)(3)(A) ☐Section 19(b)(3)(B) ☐

Rule

☐ 19b-4(f)(1) ☐ 19b-4(f)(4)
☐ 19b-4(f)(2) ☐ 19b-4(f)(5)
☐ 19b-4(f)(3) ☐ 19b-4(f)(6)

Pilot ☐ Extension of Time Period
for Commission Action ☐ Date Expires

Exhibit 2 Sent As Paper Document
☐

Exhibit 3 Sent As Paper Document
☐

Description

Provide a brief description of the proposed rule change (limit 250 characters).

Add new IM-3060 to require members to adopt written policies and procedures concerning business entertainment.

Contact Information

Provide the name, telephone number and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the proposed rule change.

First Name Last Name
Title
E-mail
Telephone Fax

Signature

Pursuant to the requirements of the Securities Exchange Act of 1934,

has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

Date By
(Name)

(Title)

NOTE: Clicking the button at right will digitally sign and lock
this form. A digital signature is as legally binding as a physical
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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EFFT website.

Form 19b-4 Information

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The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.

Exhibit 1 - Notice of Proposed Rule Change

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The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications

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Exhibit Sent As Paper Document

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Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.

Exhibit 3 - Form, Report, or Questionnaire

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Exhibit Sent As Paper Document

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Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.

Exhibit 4 - Marked Copies

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The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.

Exhibit 5 - Proposed Rule Text

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The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.

Partial Amendment

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If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ the National Association of Securities Dealers, Inc. (“NASD”) is filing with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to adopt Interpretive Material (“IM”) to NASD Rule 3060 to require members to adopt policies and procedures addressing business entertainment. Below is the text of the proposed rule change. Proposed new language is underlined.

* * * * *

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 business entertainment of the employees of a person who is a customer of the member. This interpretation does not apply to any non-cash compensation that falls within Rule 2820(g) or Rule 2830(l) (i.e., entertainment provided by offerors to associated persons of broker-dealers in connection with the sale and distribution of securities).² This interpretation supersedes any prior interpretive letters or statements of NASD staff regarding business entertainment under Rule 3060.³

¹ 15 U.S.C. 78s(b)(1).

² NASD published a Notice to Members requesting comment on a proposed rule change to replace Rules 2820(g) and 2830(l), among others, with a new Rule 2311. See Notice to Members 05-40 (June 2005). If such a rule change is proposed and approved, NASD will amend the language of proposed IM-3060 to reflect the change.

³ However, as discussed in Item 3 below, the proposed rule change does not alter our prior guidance provided in Notice to Members 99-55 (July 1999) that promotional items of nominal value that display the offeror’s logo, such as golf balls, shirts, towels and pens do not count towards the \$100 gift limit.

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 act on behalf of the account in some capacity in respect of such account or customer relationship with the member. The term “employee” means all persons who are employees, officers, directors, agents or representatives of a customer.

The term “business entertainment” means entertainment provided 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. If an employee is not accompanied by a person associated with a member, expenses associated with the entertainment will be considered a gift under Rule 3060 unless exigent circumstances make it impracticable for an associated person to attend. All instances where such exigent circumstances are invoked must be clearly and thoroughly documented and be subject to the prior written approval of a designated supervisory person or, if such approval is impractical, to a prompt post-event review to be conducted and documented by such supervisory person.

Any thing of value given to an employee that is not defined as business 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) 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;

(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 appropriate supervisory or compliance personnel have 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 business 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.

* * * * *

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

The proposed rule change was approved by the Board of Directors of NASD Regulation, Inc. at its meeting on November 30, 2005, which authorized the filing of the rule change with the SEC. Counsel for The Nasdaq Stock Market and NASD Dispute Resolution have been provided an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by NASD to its Subsidiaries. The Board of Governors of NASD had an opportunity to review the proposed rule change at its meeting on December 1, 2005. No other action by NASD is necessary for the filing of the proposed rule change. Section 1(a)(iii) of Article VII of the NASD By-Laws permits the Board of Governors of NASD to issue orders/interpretations, including interpretations of NASD Rules, without recourse to the membership for approval.

NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The

effective date of the requirement that members adopt appropriate policies and procedures concerning business entertainment will be 90 days following publication of the Notice to Members announcing Commission approval. The effective date of the recordkeeping requirements of the proposed rule change will be one year following publication of the Notice to Members.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

(1) Background

NASD 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. In 1999, NASD staff issued an interpretive 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 the entertainment "is neither so frequent nor so extensive as to raise any question of propriety."⁴ The 1999 Letter noted that the interpretation was based, in part, on NASD's rules governing non-cash compensation in connection with the offer and sale of investment company shares and variable annuities.

Recently, NASD members have requested more clarity on the rules concerning gifts and business entertainment in the wake of press reports of NASD enforcement

⁴ 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"), available at http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_002715.

actions regarding gifts and gratuities.⁵ In response to these requests, NASD is proposing interpretive material to NASD Rule 3060 to outline the policies and procedures that a member must adopt in connection with its business entertainment practices. The proposed rule change would supersede any prior guidance of NASD regarding business entertainment under Rule 3060, including the 1999 Letter. The proposed rule change would not supersede any guidance provided under other NASD rules.⁶ NASD has also clarified that any non-cash compensation falling under Rule 2820(g) or Rule 2830(l) would be subject to the standards imposed by those rules.

Rule 3060 is intended to protect from improprieties that may arise when members or their associated persons give gifts or gratuities to employees of a customer. To guard against these improprieties, Rule 3060 imposes a \$100 annual limit on gifts and gratuities that a member or associated person can give to an employee of a customer in relation to the employer firm's business. However, ordinary and usual business entertainment is not considered a gift or gratuity and is permitted "so long as it is neither so frequent nor so extensive as to raise any question of propriety." The proposed rule change is intended to replace this formulation of permitted business entertainment with an approach that permits each member to adopt specific policies and procedures tailored to its business

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 Jefferies, 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.

⁶ For example, the proposed rule change would not supersede the guidance given by NASD staff in Notice to Members 99-55 (July 1999) concerning NASD Rules 2820 and 2830.

needs. The proposed rule change also seeks to provide members with general guidance concerning the types of issues that a firm's policies and procedures must address and mandates that each member maintain appropriate records to ensure that its associated persons are complying with the written policies and procedures.

In general, NASD, working closely with the New York Stock Exchange (the "NYSE"), concluded that, in clarifying a member's obligation under Rule 3060, a specific standard was unworkable and impractical.⁷ As NASD noted in the Notice to Members seeking comment on the proposed rule change, "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."⁸ Rather, the proposed rule change requires that each member assess its use of business entertainment, determine what limitations are appropriate and meet the general guidelines set forth in the proposed rule change, and adopt written policies and procedures to ensure that its associated persons are following those limitations. While, as discussed below, some commenters criticized a general, principles-based approach as lacking clarity and uniform standards, NASD and the NYSE both concluded that such an approach was more appropriate. The proposed rule change expands upon the existing principles-based approach to business entertainment established in the 1999 Letter but specifically addresses the content of a member's written policies and procedures and provides more guidance concerning the acceptable forms of business entertainment.

⁷ The NYSE has also filed a proposed rule change with the Commission addressing business entertainment. See SR-NYSE-2006-06 (proposing new NYSE Rule 350A).

⁸ See Notice to Members 06-06 (Jan. 2006).

(2) Definitions

There are three defined terms that are integral to an understanding of the proposed rule change. First, “customer” is defined as “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 act on behalf of the account in some capacity in respect of such account or customer relationship with the member.” Under this definition, the proposed rule change would not include business entertainment provided to a natural person customer; it addresses only business entertainment provided to an “employee” of the customer (although such customer may be a natural or non-natural person).

Second, for purposes of the proposed rule change, an “employee” includes “all persons who are employees, officers, directors, agents or representatives of a customer.”

Third, “business entertainment” is defined as “entertainment provided 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.” This definition codifies NASD’s long-standing position that a member must accompany or participate in an event for it to be deemed “business entertainment” rather than a “gift.”

In response to several comments, NASD has proposed an exception to this position to accommodate situations in which a person associated with a member cannot accompany the employee of the customer at the business entertainment event because of exigent circumstances, provided that these circumstances are clearly and thoroughly documented and are subject to appropriate approval. One commenter asked for detailed definitions of “accompany” and “participate.” NASD staff believes that it is impractical to define these terms because the determination of whether an associated person of a member accompanies and participates with an employee of a customer is dependent on the particular facts and circumstances. However, if interpretive questions are presented, NASD staff will consider whether providing additional guidance in the form of a letter or a series of questions and answers is appropriate. The definition also makes clear that any thing of value given to an employee that is not defined as “business entertainment” is a gift under Rule 3060 and that “business entertainment” includes transportation and lodging expenses provided by the member related to a business entertainment activity or event.

(3) Policies and Procedures

The proposed rule change codifies the general principle that a member and 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. To effectuate this principle, the proposed rule change requires members to adopt written policies and procedures concerning business entertainment that: (1) determine and define forms of business entertainment that are

appropriate and inappropriate; (2) are designed to promote conduct of the member and its associated persons that is consistent with their obligations under NASD Rule 2110 and does not undermine the performance of an employee's duty to a customer; (3) are designed to effectively supervise compliance with the member's written policies and procedures; (4) are designed to maintain appropriate records of the nature and expense of business entertainment in excess of \$50 and make such information available to a customer upon written request 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 of 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.

(A) Determine and Define Forms of Appropriate and Inappropriate Business Entertainment

The member's written policies and procedures concerning business entertainment must determine and define forms of business entertainment that are appropriate and inappropriate, including appropriate venues, nature, frequency, types and class of accommodation and transportation, and either establish firm dollar limits or thresholds requiring advance written approval. The proposed rule change does not impose hard limits or require that all members adopt the same limits or treat all recipients equally. However, the member's policies and procedures cannot be so vague or unbounded that no reasonable determination of propriety can be made. The proposed rule change would also allow, but not require, members to establish different standards for business

entertainment in connection with events that are educational, charitable, or philanthropic in nature.

(B) Promote Conduct Consistent with NASD Rule 2110

The member's policies and procedures must be designed to promote conduct consistent with NASD 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 that an employee would likely feel compelled to act in a manner inconsistent with the interests of his or her employer. NASD does not intend that this standard would establish a per se violation of the proposed IM if an employee who received business entertainment from the member is later found to have violated his or her obligations to his or her employer; however, such actions by a customer's employee may warrant further investigation by the member firm as to whether the member's policies and procedures are, in fact, reasonably tailored to prevent these types of violations.⁹ While NASD members are not ultimately responsible for the conduct of its customers' employees, members are responsible for ensuring that their associated persons do not engage in activities that are designed to, or reasonably likely to, cause the recipient to engage in improper conduct. Moreover, a member's compliance with its policies and procedures would not serve to automatically shield the member from all liability under the proposed IM for any misconduct by a customer's employee.

⁹ NASD Rule 3012(a) requires members to test and verify their supervisory procedures and "create additional or amend supervisory procedures where the need is identified by such testing and verification."

(C) Effective Supervision

A member's policies and procedures must provide for effective supervision and compliance with the member's business entertainment policies. While members are free to define the approach and method of their written policies and procedures, they must comport with the principles identified in the proposed rule change. For example, the factors used to determine appropriate levels of business entertainment and how the determinations are executed, monitored, and enforced must be clear. The supervisory procedures should also provide a method for evidencing both the breadth of supervisory activities as well as the information upon which such supervision is conducted.

(D) Recordkeeping

The only effective way for a member to ensure that its associated persons are following the firm's policies and procedures is to establish a system to track the business entertainment expenses of its associated persons. Consequently, a member's policies and procedures are required to include procedures regarding the maintenance of detailed records of business entertainment expenses in excess of \$50 and the establishment of appropriate procedures to make such information available to the customer in respect of its employees upon written request. In establishing a \$50 threshold, NASD seeks to address the potential burden associated with tracking small expenditures, none of which would reasonably be expected to influence the behavior of the recipient. The \$50 threshold would apply only to events or activities with a total cost that did not exceed \$50 (e.g., an inexpensive lunch) or to minor expenses related to an otherwise reported business entertainment event (such as a hot dog at an NBA basketball game, where the basketball game ticket is reported as a business entertainment expense). Firms may not

allow their associated persons to disaggregate business entertainment expenses relating to an activity or event in an effort to avoid recordkeeping obligations. Thus, a dinner expense of \$40 followed by a sporting event with a ticket price of \$40 would need to be tracked under the member's recordkeeping system.

One of the key elements of the proposed rule change is the ability of a customer to request from the member information regarding the business entertainment expenses provided to the customer's employees. While members are permitted to establish reasonable guidelines regarding a customer's ability to request information with regard to its employees, such guidelines must not impair the ability of the customer to obtain, on a reasonable and regular basis, information concerning the member's business entertainment expenses pertaining to the employees of such customer.

Finally, in recognition of the systems changes that the proposed rule change may necessitate, NASD has proposed an effective date for the recordkeeping requirements of one year following the publication of a Notice to Members announcing the Commission's approval of the proposed rule change.

(E) Supervision, Approval, Documentation, and Monitoring

Members 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. The requirement that the person designated to supervise business entertainment expenses be "sufficiently qualified" is not intended to impose a registration requirement or similar obligation on the individual; rather, the requirement is intended to ensure that the member's designation is of a person who is familiar with the applicable

regulatory requirements and is sufficiently senior and experienced to entrust with the approval obligations envisioned by the member's policies and procedures.

The proposed rule change also notes that the periodic monitoring of business entertainment should be conducted by an "independent reviewer," where practicable. For purposes of this provision, a person who is "independent" must not participate in the business entertainment, supervise such persons, or be part of the business unit or department that provides or seeks to provide investment banking or securities business to the customer. The term "independent" does not require that "unaffiliated" or outside personnel perform the review. A member firm may use personnel from a separate office within, or affiliated with, the member firm for purposes of conducting the review, including accounting, finance, internal audit, or compliance.

(F) Training and Education

The member's business entertainment policies and procedures must also require appropriate training and education to all applicable personnel. 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.

(4) Effective Date

As noted in Item 2 of this filing, NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The effective date of the requirement that members adopt appropriate policies and procedures concerning business entertainment will be 90 days following publication of the Notice to Members announcing Commission approval.

The effective date of the recordkeeping requirements of the proposed rule change will be one year following publication of the Notice to Members.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,¹⁰ which requires, among other things, that NASD rules must 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. NASD believes that the proposed rule change clarifies existing obligations of members with respect to the provision of business entertainment and will help prevent conduct by associated persons that could undermine the performance of an employee's duty to the member's customer.

4. Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The proposed rule change was published for comment in NASD Notice to Members 06-06 (Jan. 2006). NASD received 28 comments in response to the Notice.¹¹

¹⁰ 15 U.S.C. 78o-3(b)(6).

¹¹ Letter from Pinnacle Taxx Advisors, Inc. ("Pinnacle"), dated Jan. 26, 2006; Letter from Keefe, Bruyette & Woods ("KBW"), dated Jan. 26, 2006; Letter from J.P. Morgan, dated Jan. 30, 2006; Letter from Evolve Securities, Inc. ("Evolve"), dated Jan. 31, 2006; Letter from Seasingood & Mayer, LLC ("Seasingood"), dated Feb. 2, 2006; Letter from Plexus Consulting ("Plexus") o/b/o International Association of Small Broker Dealers and Advisers, dated Feb. 6, 2006; Letter from Dominion Investor Services, Inc. ("Dominion"), dated Feb. 13, 2006; Letter from National Regulatory Services ("NRS"), dated Feb. 6, 2006; Letter from T.

A copy of the Notice to Members is attached as Exhibit 2a. A list of the comments received in response to the Notice is attached as Exhibit 2b, and copies of the comment letters received in response to the Notice are attached as Exhibit 2c. Of the 28 comment letters received, 12 were generally in favor of the proposed rule change, 13 were opposed, and three took no clear position.

A number of commenters raised concerns with NASD's general, principles-based approach to the proposed rule change¹² and questioned the overall need for the IM.¹³ As

Rowe Price Investment Services, Inc. ("T. Rowe Price"), dated Feb. 17, 2006. Letter from Maplewood Investment Advisors, Inc. ("Maplewood"), dated Feb. 22, 2006; Letter from Financial Services Institute, Inc. ("FSI"), dated Feb. 23, 2006; Letter from Transamerica Financial Advisors, Inc. ("Transamerica"), dated Feb. 23, 2006; Letter from H.D. Vest Financial Services ("H.D. Vest"), dated Feb. 23, 2006; Letter from ING US Financial Services ("ING"), dated Feb. 23, 2006; Letter from The Investment Company Institute ("ICI"), dated Feb. 23, 2006; Letter from Hines Real Estate Securities, Inc. ("Hines"), dated Feb. 21, 2006; Letter from The National Society of Compliance Professionals ("NSCP"), dated Feb. 23, 2006; Letter from Financial Network, dated Feb. 23, 2006; Letter from Coker Palmer, dated Feb. 23, 2006; Letter from Griffin, Kubik, Stephens & Thompson, Inc. ("Griffin"), dated Mar. 2, 2006; Letter from Debevoise & Plimpton LLP ("Debevoise") o/b/o The Midtown Regulatory Group, dated Mar. 3, 2006; Letter from Transamerica Capital, Inc. ("Transamerica Capital"), dated Mar. 3, 2006; Letter from The Bond Market Association ("BMA"), dated Mar. 3, 2006; Letter from Goodwin Browning & Luna Securities, Inc. ("GB&L"), dated Mar. 3, 2006; Letter from The ABA Securities Association ("ABASA"), dated Mar. 3, 2006; Letter from Wachovia Capital Markets, LLC ("Wachovia"), dated Mar. 3, 2006; Letter from Neal E. Nakagiri ("Nakagiri"), dated Mar. 3, 2006; Letter from The Self-Regulation and Supervisory Practices Committee of the Securities Industry Association ("SIA"), dated Mar. 7, 2006.

¹² See, e.g., Letters from Dominion, Financial Network, H.D. Vest, Hines, Plexus, and NRS.

¹³ See, e.g., Letters from Evolve, Financial Network, FSI, GB&L, H.D. Vest, ING, Maplewood, Nakagiri, and Transamerica Capital. Several commenters indicated that the proposed rule change should be made through notice and comment rulemaking with the Commission. As the Notice to Members stated, Section 19 of the Act requires that proposed rule changes such as IM-3060 be approved by

indicated above, the proposed rule change was undertaken in response to requests by NASD members for clarity concerning appropriate business entertainment. Both NASD and the NYSE undertook to provide members with additional guidance following these requests. To the extent some commenters questioned whether NASD should seek to “regulate” the employees of their members’ customers, these commenters fail to recognize that NASD staff guidance in the 1999 Letter already prohibits business entertainment for employees of customers that is so frequent or excessive as to raise questions of propriety. Moreover, as discussed above, NASD is not seeking to regulate the behavior of the employees of a member’s customers;¹⁴ rather, NASD is requiring members to develop and enforce some appropriate degree of limitation on the business entertainment its associated persons provide to its customers’ employees. In achieving this end, both NASD and the NYSE believe that a general, principles-based approach is more appropriate than a restrictive, one-size-fits-all regulatory scheme. Given the significant variation in broker-dealer business models and size, and regional differences in what may be considered appropriate business entertainment, NASD concluded that a fixed-dollar standard or similar specific mandate would prove unworkable.

the Commission following publication for public comment in the Federal Register. See Notice to Members 06-06, at 2 & n.2.

¹⁴ NASD recognizes that customers whose employees receive business entertainment have the responsibility to ensure that their employees do not engage in improper conduct. However, NASD believes that the person providing business entertainment cannot disclaim any responsibility for improper conduct that flows directly from business entertainment its employee provided when the employee either intended for the business entertainment to have that effect or could reasonably have judged that the business entertainment would be likely to have that effect.

One commenter suggested that NASD exempt certain small broker-dealers, at least in part because they lack the resources to affect decision-making in the manner the IM seeks to prohibit and that such extravagant and extensive business entertainment is localized among larger firms and does not occur in rural or small-market areas.¹⁵ NASD staff disagrees with the contention that a small firm's business entertainment activities cannot influence the behavior of a customer's employee or that improper business entertainment is limited to large, urban areas. NASD believes that the proposed rule change should apply to all members, though each member may adopt written policies and procedures that reflect its specific business and practices. NASD expects and understands that there may be a wide variance among the policies and procedures firms adopt pursuant to this rule interpretation. Under the proposed rule change, a small firm is permitted to tailor its written policies and procedures governing business entertainment to reflect its particular business model and customer base.

Several commenters suggested that NASD identify in the IM the specific factors to be considered by firms in developing their written policies and procedures, such as those identified by the NYSE in its rule filing. NASD staff does not believe it is necessary to identify specific factors in the IM and that doing so may undermine the flexibility the proposed rule change is designed to achieve.¹⁶ In addition, NASD staff notes that the NYSE also has not chosen to put these criteria in its proposed rule, but rather intends to include them in an Information Memo to be released in conjunction with the approval of its proposed rule change. NASD staff will consider whether additional

¹⁵ Letter from Evolve.

¹⁶ See Letter from BMA.

guidance concerning the IM is necessary when announcing the proposed rule change in a Notice to Members.

Several commenters expressed concern that the proposed rule change, including some of the defined terms, was too vague and may, in application, prove overly broad. Among other things, these commenters suggested that the proposed rule change could disadvantage firms with more conservative policies and procedures,¹⁷ effectively require pre-approval of all business entertainment,¹⁸ and could introduce disadvantages among different types of firms and other industry participants.¹⁹ Other commenters believed that the principles-based approach proposed by NASD is the appropriate manner to address the needed clarification of business entertainment.

While NASD recognizes that there will be distinctions among each member's written policies and procedures, NASD concluded that member firms were in the best position to determine appropriate limitations and restrictions on the business entertainment provided by their associated persons. After considering the various comments concerning the definitions of "customer" and "business entertainment" in the proposed rule change,²⁰ NASD has determined not to amend the definitions. While several commenters recommended that the definition of customer track the definition of "accredited investor" as defined in SEC Rule 501 under the Securities Act of 1933, NASD staff does not believe that the application of the IM should be dependent on any

¹⁷ See, e.g., Letters from Hines and ING.

¹⁸ See Letter from Transamerica Capital.

¹⁹ See, e.g., Letters from Dominion and Seasongood.

particular level of assets. While member firms may choose to treat certain types of customers or certain types of business entertainment differently for purposes of their written policies and procedures, NASD believes that, for purposes of the proposed rule change, a broad definition of each is appropriate.

With respect to one comment, NASD believes that it would be appropriate for a member's written policies and procedures to allow case-by-case review and approval for types of entertainment not specifically set forth in the member's policies and procedures.²¹ One commenter was concerned that a registered representative may not be aware whether a recipient of business entertainment is an employee of a customer of the firm.²² If a person is entertained in his personal capacity as a natural person client, and the firm has information barriers that would prevent the person providing the business entertainment from knowing that the person represents another customer as an employee, and the person providing business entertainment has no knowledge that such person is an employee of a customer at the time of the business entertainment, then such entertainment would fall outside the scope of the IM.

Several commenters raised suggestions concerning Rule 3060's limitation on gifts and gratuities, ranging from comments focused on increasing the \$100 limitation, moving from a hard figure standard to a principles-based approach, and providing guidance on the types of gifts and incidental expenses that should be included or excluded from any

²⁰ See, e.g., Letters from BMA, Financial Network, FSI, ING, and Transamerica Capital.

²¹ See Letter from Debevoise.

²² See Letter from FSI.

limitation.²³ The proposed rule change is focused on business entertainment, which is excepted from the limitation on “gifts,” and NASD is not currently considering amending the rule regarding gifts and gratuities.²⁴ NASD has long recognized that gifts – in contrast to business entertainment – are not incidental to the transaction of business. NASD requires that any gifts be de minimis and sees no reason to depart from this long-held view. NASD does not believe that the proposed rule change is the appropriate forum for providing interpretive advice on other aspects of Rule 3060; however, parties seeking interpretive guidance concerning the \$100 limitation on gifts and gratuities can submit an interpretive letter to the NASD staff in the Office of General Counsel.

One commenter expressed concern that the IM shifts the burden of proof required under Rule 3060 and suggested that any change to Rule 3060 be done through a separate rule proposal rather than through an IM. As discussed in footnote 13, the IM, which is the equivalent of a rule change, is being proposed in accordance with the procedures for a proposed rule change under Section 19 of the Act. NASD has chosen for narrative stylistic purposes to designate this proposed rule change as interpretive material. Rule 3060 and IM-3060 are two separate provisions, and the burden of proof under Rule 3060 is not affected by the proposed rule change.

²³ See, e.g., Letters from ABASA, BMA, Debevoise, Evolve, Financial Network, and Wachovia.

²⁴ The one exception is the one noted above with respect to exigent circumstances. Numerous commenters requested that NASD adopt the exigent circumstances exception from the gift rule similar to the exception that the NYSE has proposed. See, e.g., Letters from ABASA, BMA, and Wachovia. As discussed above, NASD has determined that it is appropriate to provide for such an exception.

Several commenters appeared concerned that the discussion in footnote five of the Notice would prohibit entertaining friends and relatives. This misconstrues the meaning of footnote five, which says: “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.” What is required by footnote five is that an associated person not avoid the application of the firm’s business entertainment policies by claiming such entertainment is “personal” rather than business. Firms are, however, likely to include policies in their business entertainment procedures to address personal entertainment of employees of a customer where there is a family or some other personal relationship, much the way firms do today for gifts and gratuities under Rule 3060.

Many commenters requested clarification on whether an “independent” review could be conducted by an independent department within, or affiliated with, the member.²⁵ As noted above, NASD believes that an independent department or business unit within, or affiliated with, a member would be independent within the meaning of the term in the proposed rule change. The ICI also suggested that the frequency of the reviews be left within the discretion of the individual member. NASD agrees that it is appropriate to leave the issue of frequency of the reviews to the individual member firm; however, NASD notes that the member’s written policies and procedures should address

²⁵ See, e.g., Letters from Debevoise, Evolve, ICI, KBW, NRS, Transamerica Capital, and Wachovia.

the frequency of the reviews and should, in general, provide for a specific frequency (e.g., quarterly, annually, etc.).

Many commenters expressed concern with the breadth of the recordkeeping requirement and requested a lengthy implementation time for the recordkeeping requirements.²⁶ In response to these comments, NASD provided an exception from the recordkeeping obligations for expenses of \$50 or less. However, as discussed above, NASD believes that a member's policies and procedures should prevent associated persons from intentionally avoiding the \$50 requirement by breaking up what are otherwise connected costs or by engaging in frequent, repeated business entertainment at amounts below the \$50 threshold. For example, a firm's policies and procedures may require associated persons to submit all business entertainment expenses for review; however, the firm may decide to record and track only amounts over \$50. NASD is also providing for an effective date of one year following NASD's publication of a Notice to Members announcing the Commission's approval of the proposed rule change. NASD believes that one year will allow members sufficient time to implement recordkeeping systems to comply with the proposed rule change.

In response to a comment from Debevoise, NASD has amended one of the examples in the proposed rule change to reflect that firms may choose to require approval from "appropriate supervisory or compliance personnel" rather than "senior management." While the commenter noted that the surrounding language was not intended to be prescriptive, NASD concluded that a broader term was appropriate in this

²⁶ See, e.g., Letters from Evolve, Financial Network, FSI, H.D. Vest, ICI, ING, Maplewood, and Transamerica Capital.

context. As the proposed rule change notes, the supervisory procedures a member adopts are within the discretion of each member; however, the procedures should recognize that supervision is a critical component of any written policies and procedures and should be reasonably designed to comport with the principles stated in the proposed rule change.

One commenter suggested that NASD permit a member's procedures to include prompt review of business entertainment after the event.²⁷ The commenter offered an example of a dinner that unexpectedly exceeds the firm's threshold. NASD does not believe that a member's policies and procedures should allow for post-event approval because there does not appear to be an effective means of rescinding business entertainment that has already been provided. Rather, associated persons who are concerned that the cost of an event may exceed the threshold should request approval in advance to go over the firm's limit. In such a situation, the member should impose another dollar limit rather than simply waive the requirement.

Finally, several commenters requested that NASD and NYSE harmonize their proposed rule changes or, in the alternative, include a provision that a dual member that complies with one of the SRO's rule will be deemed to be in compliance with the other SRO's rule.²⁸ In response to these comments, NASD has sought to address substantive disparities between its rule and that of the NYSE.

²⁷ See Letter from T. Rowe Price.

²⁸ See, e.g., Letters from BMA and SIA.

6. **Extension of Time Period for Commission Action**

NASD does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.²⁹

7. **Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)**

Not applicable.

8. **Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission**

Not applicable.

9. **Exhibits**

Exhibit 1. Completed notice of proposed rule change for publication in the Federal Register.

Exhibit 2a. NASD Notice to Members 06-06 (Jan. 2006).

Exhibit 2b. List of comments received in response to NASD Notice to Members 06-06 (Jan. 2006).

Exhibit 2c. Comments received in response to NASD Notice to Members 06-06 (Jan. 2006).

²⁹

15 U.S.C. 78s(b)(2).

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-NASD-2006-044)

Self-Regulatory Organizations: National Association of Securities Dealers, Inc.; Notice of Filing of Proposed Rule Change Relating to Interpretive Material to NASD Rule 3060 to Require Members to Adopt Policies and Procedures Addressing Business Entertainment

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 , the National Association of Securities Dealers, Inc. ("NASD") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

NASD is proposing to adopt Interpretive Material ("IM") to NASD Rule 3060, to require members to adopt policies and procedures addressing business entertainment. Below is the text of the proposed rule change. Proposed new language is in italics.

* * * * *

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 business entertainment of the employees

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

of a person who is a customer of the member. This interpretation does not apply to any non-cash compensation that falls within Rule 2820(g) or Rule 2830(l) (i.e., entertainment provided by offerors to associated persons of broker-dealers in connection with the sale and distribution of securities).³ This interpretation supersedes any prior interpretive letters or statements of NASD staff regarding business entertainment under Rule 3060.⁴

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 act on behalf of the account in some capacity in respect of such account or customer relationship with the member. The term “employee” means all persons who are employees, officers, directors, agents or representatives of a customer.

The term “business entertainment” means entertainment provided 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.

³ NASD published a Notice to Members requesting comment on a proposed rule change to replace Rules 2820(g) and 2830(l), among others, with a new Rule 2311. See Notice to Members 05-40 (June 2005). If such a rule change is proposed and approved, NASD will amend the language of proposed IM-3060 to reflect the change.

⁴ However, as discussed in Item 3 below, the proposed rule change does not alter our prior guidance provided in Notice to Members 99-55 (July 1999) that promotional items of nominal value that display the offeror’s logo, such as golf balls, shirts, towels and pens do not count towards the \$100 gift limit.

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. If an employee is not accompanied by a person associated with a member, expenses associated with the entertainment will be considered a gift under Rule 3060 unless exigent circumstances make it impracticable for an associated person to attend. All instances where such exigent circumstances are invoked must be clearly and thoroughly documented and be subject to the prior written approval of a designated supervisory person or, if such approval is impractical, to a prompt post-event review to be conducted and documented by such supervisory person. Any thing of value given to an employee that is not defined as business 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) 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;

(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 appropriate supervisory or compliance personnel have 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 business 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.

* * * * *

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

(a) Background

NASD 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. In 1999, NASD staff issued an interpretive 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 the entertainment "is neither so frequent nor so extensive as to raise any question of propriety."⁵ The 1999 Letter noted that the interpretation was based, in part, on NASD's rules governing non-cash compensation in connection with the offer and sale of investment company shares and variable annuities.

Recently, NASD members have requested more clarity on the rules concerning gifts and business entertainment in the wake of press reports of NASD enforcement actions regarding gifts and gratuities.⁶ In response to these requests, NASD is proposing

⁵ 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"), available at http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_002715.

⁶ 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 Jefferies, 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.

interpretive material to NASD Rule 3060 to outline the policies and procedures that a member must adopt in connection with its business entertainment practices. The proposed rule change would supersede any prior guidance of NASD regarding business entertainment under Rule 3060, including the 1999 Letter. The proposed rule change would not supersede any guidance provided under other NASD rules.⁷ NASD has also clarified that any non-cash compensation falling under Rule 2820(g) or Rule 2830(l) would be subject to the standards imposed by those rules.

Rule 3060 is intended to protect from improprieties that may arise when members or their associated persons give gifts or gratuities to employees of a customer. To guard against these improprieties, Rule 3060 imposes a \$100 annual limit on gifts and gratuities that a member or associated person can give to an employee of a customer in relation to the employer firm's business. However, ordinary and usual business entertainment is not considered a gift or gratuity and is permitted "so long as it is neither so frequent nor so extensive as to raise any question of propriety." The proposed rule change is intended to replace this formulation of permitted business entertainment with an approach that permits each member to adopt specific policies and procedures tailored to its business needs. The proposed rule change also seeks to provide members with general guidance concerning the types of issues that a firm's policies and procedures must address and mandates that each member maintain appropriate records to ensure that its associated persons are complying with the written policies and procedures.

⁷ For example, the proposed rule change would not supersede the guidance given by NASD staff in Notice to Members 99-55 (July 1999) concerning NASD Rules 2820 and 2830.

In general, NASD, working closely with the New York Stock Exchange (the “NYSE”), concluded that, in clarifying a member’s obligation under Rule 3060, a specific standard was unworkable and impractical.⁸ As NASD noted in the Notice to Members seeking comment on the proposed rule change, “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.”⁹ Rather, the proposed rule change requires that each member assess its use of business entertainment, determine what limitations are appropriate and meet the general guidelines set forth in the proposed rule change, and adopt written policies and procedures to ensure that its associated persons are following those limitations. While, as discussed below, some commenters criticized a general, principles-based approach as lacking clarity and uniform standards, NASD and the NYSE both concluded that such an approach was more appropriate. The proposed rule change expands upon the existing principles-based approach to business entertainment established in the 1999 Letter but specifically addresses the content of a member’s written policies and procedures and provides more guidance concerning the acceptable forms of business entertainment.

(b) Definitions

There are three defined terms that are integral to an understanding of the proposed rule change. First, “customer” is defined as “a person that maintains, or whose employee receives business entertainment for the purpose of having such person prospectively

⁸ The NYSE has also filed a proposed rule change with the Commission addressing business entertainment. See SR-NYSE-2006-06 (proposing new NYSE Rule 350A).

⁹ See Notice to Members 06-06 (Jan. 2006).

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 act on behalf of the account in some capacity in respect of such account or customer relationship with the member.” Under this definition, the proposed rule change would not include business entertainment provided to a natural person customer; it addresses only business entertainment provided to an “employee” of the customer (although such customer may be a natural or non-natural person).

Second, for purposes of the proposed rule change, an “employee” includes “all persons who are employees, officers, directors, agents or representatives of a customer.”

Third, “business entertainment” is defined as “entertainment provided 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.” This definition codifies NASD’s long-standing position that a member must accompany or participate in an event for it to be deemed “business entertainment” rather than a “gift.”

In response to several comments, NASD has proposed an exception to this position to accommodate situations in which a person associated with a member cannot accompany the employee of the customer at the business entertainment event because of exigent circumstances, provided that these circumstances are clearly and thoroughly

documented and are subject to appropriate approval. One commenter asked for detailed definitions of “accompany” and “participate.” NASD staff believes that it is impractical to define these terms because the determination of whether an associated person of a member accompanies and participates with an employee of a customer is dependent on the particular facts and circumstances. However, if interpretive questions are presented, NASD staff will consider whether providing additional guidance in the form of a letter or a series of questions and answers is appropriate. The definition also makes clear that any thing of value given to an employee that is not defined as “business entertainment” is a gift under Rule 3060 and that “business entertainment” includes transportation and lodging expenses provided by the member related to a business entertainment activity or event.

(c) Policies and Procedures

The proposed rule change codifies the general principle that a member and 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. To effectuate this principle, the proposed rule change requires members to adopt written policies and procedures concerning business entertainment that: (1) determine and define forms of business entertainment that are appropriate and inappropriate; (2) are designed to promote conduct of the member and its associated persons that is consistent with their obligations under NASD Rule 2110 and does not undermine the performance of an employee’s duty to a customer; (3) are designed to effectively supervise compliance with the member’s written policies and

procedures; (4) are designed to maintain appropriate records of the nature and expense of business entertainment in excess of \$50 and make such information available to a customer upon written request 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 of 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.

(1) Determine and Define Forms of Appropriate and Inappropriate Business Entertainment

The member's written policies and procedures concerning business entertainment must determine and define forms of business entertainment that are appropriate and inappropriate, including appropriate venues, nature, frequency, types and class of accommodation and transportation, and either establish firm dollar limits or thresholds requiring advance written approval. The proposed rule change does not impose hard limits or require that all members adopt the same limits or treat all recipients equally. However, the member's policies and procedures cannot be so vague or unbounded that no reasonable determination of propriety can be made. The proposed rule change would also allow, but not require, members to establish different standards for business entertainment in connection with events that are educational, charitable, or philanthropic in nature.

(2) Promote Conduct Consistent with NASD Rule 2110

The member's policies and procedures must be designed to promote conduct consistent with NASD 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 that an employee would likely feel compelled to act in a manner inconsistent with the interests of his or her employer. NASD does not intend that this standard would establish a per se violation of the proposed IM if an employee who received business entertainment from the member is later found to have violated his or her obligations to his or her employer; however, such actions by a customer's employee may warrant further investigation by the member firm as to whether the member's policies and procedures are, in fact, reasonably tailored to prevent these types of violations.¹⁰ While NASD members are not ultimately responsible for the conduct of its customers' employees, members are responsible for ensuring that their associated persons do not engage in activities that are designed to, or reasonably likely to, cause the recipient to engage in improper conduct. Moreover, a member's compliance with its policies and procedures would not serve to automatically shield the member from all liability under the proposed IM for any misconduct by a customer's employee.

(3) Effective Supervision

A member's policies and procedures must provide for effective supervision and compliance with the member's business entertainment policies. While members are free to define the approach and method of their written policies and procedures, they must comport with the principles identified in the proposed rule change. For example, the factors used to determine appropriate levels of business entertainment and how the

¹⁰ NASD Rule 3012(a) requires members to test and verify their supervisory procedures and "create additional or amend supervisory procedures where the need is identified by such testing and verification."

determinations are executed, monitored, and enforced must be clear. The supervisory procedures should also provide a method for evidencing both the breadth of supervisory activities as well as the information upon which such supervision is conducted.

(4) Recordkeeping

The only effective way for a member to ensure that its associated persons are following the firm's policies and procedures is to establish a system to track the business entertainment expenses of its associated persons. Consequently, a member's policies and procedures are required to include procedures regarding the maintenance of detailed records of business entertainment expenses in excess of \$50 and the establishment of appropriate procedures to make such information available to the customer in respect of its employees upon written request. In establishing a \$50 threshold, NASD seeks to address the potential burden associated with tracking small expenditures, none of which would reasonably be expected to influence the behavior of the recipient. The \$50 threshold would apply only to events or activities with a total cost that did not exceed \$50 (e.g., an inexpensive lunch) or to minor expenses related to an otherwise reported business entertainment event (such as a hot dog at an NBA basketball game, where the basketball game ticket is reported as a business entertainment expense). Firms may not allow their associated persons to disaggregate business entertainment expenses relating to an activity or event in an effort to avoid recordkeeping obligations. Thus, a dinner expense of \$40 followed by a sporting event with a ticket price of \$40 would need to be tracked under the member's recordkeeping system.

One of the key elements of the proposed rule change is the ability of a customer to request from the member information regarding the business entertainment expenses

provided to the customer's employees. While members are permitted to establish reasonable guidelines regarding a customer's ability to request information with regard to its employees, such guidelines must not impair the ability of the customer to obtain, on a reasonable and regular basis, information concerning the member's business entertainment expenses pertaining to the employees of such customer.

Finally, in recognition of the systems changes that the proposed rule change may necessitate, NASD has proposed an effective date for the recordkeeping requirements of one year following the publication of a Notice to Members announcing the Commission's approval of the proposed rule change.

(5) Supervision, Approval, Documentation, and Monitoring

Members 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. The requirement that the person designated to supervise business entertainment expenses be "sufficiently qualified" is not intended to impose a registration requirement or similar obligation on the individual; rather, the requirement is intended to ensure that the member's designation is of a person who is familiar with the applicable regulatory requirements and is sufficiently senior and experienced to entrust with the approval obligations envisioned by the member's policies and procedures.

The proposed rule change also notes that the periodic monitoring of business entertainment should be conducted by an "independent reviewer," where practicable. For purposes of this provision, a person who is "independent" must not participate in the business entertainment, supervise such persons, or be part of the business unit or

department that provides or seeks to provide investment banking or securities business to the customer. The term “independent” does not require that “unaffiliated” or outside personnel perform the review. A member firm may use personnel from a separate office within, or affiliated with, the member firm for purposes of conducting the review, including accounting, finance, internal audit, or compliance.

(6) Training and Education

The member’s business entertainment policies and procedures must also require appropriate training and education to all applicable personnel. 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.

(d) Effective Date

NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The effective date of the requirement that members adopt appropriate policies and procedures concerning business entertainment will be 90 days following publication of the Notice to Members announcing Commission approval. The effective date of the recordkeeping requirements of the proposed rule change will be one year following publication of the Notice to Members.

2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,¹¹ which requires, among other things, that NASD rules must be designed to prevent fraudulent and manipulative acts and practices, to promote

¹¹ 15 U.S.C. 78o–3(b)(6).

just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that the proposed rule change clarifies existing obligations of members with respect to the provision of business entertainment and will help prevent conduct by associated persons that could undermine the performance of an employee's duty to the member's customer.

B. Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The proposed rule change was published for comment in NASD Notice to Members 06-06 (Jan. 2006). NASD received 28 comments in response to the Notice.¹²

¹² Letter from Pinnacle Taxx Advisors, Inc. ("Pinnacle"), dated Jan. 26, 2006; Letter from Keefe, Bruyette & Woods ("KBW"), dated Jan. 26, 2006; Letter from J.P. Morgan, dated Jan. 30, 2006; Letter from Evolve Securities, Inc. ("Evolve"), dated Jan. 31, 2006; Letter from Seasongood & Mayer, LLC ("Seasongood"), dated Feb. 2, 2006; Letter from Plexus Consulting ("Plexus") o/b/o International Association of Small Broker Dealers and Advisers, dated Feb. 6, 2006; Letter from Dominion Investor Services, Inc. ("Dominion"), dated Feb. 13, 2006; Letter from National Regulatory Services ("NRS"), dated Feb. 6, 2006; Letter from T. Rowe Price Investment Services, Inc. ("T. Rowe Price"), dated Feb. 17, 2006. Letter from Maplewood Investment Advisors, Inc. ("Maplewood"), dated Feb. 22, 2006; Letter from Financial Services Institute, Inc. ("FSI"), dated Feb. 23, 2006; Letter from Transamerica Financial Advisors, Inc. ("Transamerica"), dated Feb. 23, 2006; Letter from H.D. Vest Financial Services ("H.D. Vest"), dated Feb. 23, 2006; Letter from ING US Financial Services ("ING"), dated Feb. 23, 2006; Letter from The Investment Company Institute ("ICI"), dated Feb. 23, 2006; Letter from Hines Real Estate Securities, Inc. ("Hines"), dated Feb. 21, 2006; Letter from The National Society of Compliance Professionals ("NSCP"), dated Feb. 23, 2006; Letter from Financial Network, dated Feb. 23, 2006; Letter from Coker Palmer, dated Feb. 23, 2006; Letter from Griffin, Kubik, Stephens & Thompson, Inc. ("Griffin"), dated Mar. 2, 2006; Letter from Debevoise & Plimpton LLP ("Debevoise") o/b/o The Midtown Regulatory Group, dated Mar.

A copy of the Notice to Members is attached as Exhibit 2a. A list of the comments received in response to the Notice is attached as Exhibit 2b, and copies of the comment letters received in response to the Notice are attached as Exhibit 2c. Of the 28 comment letters received, 12 were generally in favor of the proposed rule change, 13 were opposed, and three took no clear position.

A number of commenters raised concerns with NASD's general, principles-based approach to the proposed rule change¹³ and questioned the overall need for the IM.¹⁴ As indicated above, the proposed rule change was undertaken in response to requests by NASD members for clarity concerning appropriate business entertainment. Both NASD and the NYSE undertook to provide members with additional guidance following these requests. To the extent some commenters questioned whether NASD should seek to "regulate" the employees of their members' customers, these commenters fail to recognize that NASD staff guidance in the 1999 Letter already prohibits business

3, 2006; Letter from Transamerica Capital, Inc. ("Transamerica Capital"), dated Mar. 3, 2006; Letter from The Bond Market Association ("BMA"), dated Mar. 3, 2006; Letter from Goodwin Browning & Luna Securities, Inc. ("GB&L"), dated Mar. 3, 2006; Letter from The ABA Securities Association ("ABASA"), dated Mar. 3, 2006; Letter from Wachovia Capital Markets, LLC ("Wachovia"), dated Mar. 3, 2006; Letter from Neal E. Nakagiri ("Nakagiri"), dated Mar. 3, 2006; Letter from The Self-Regulation and Supervisory Practices Committee of the Securities Industry Association ("SIA"), dated Mar. 7, 2006.

¹³ See, e.g., Letters from Dominion, Financial Network, H.D. Vest, Hines, Plexus, and NRS.

¹⁴ See, e.g., Letters from Evolve, Financial Network, FSI, GB&L, H.D. Vest, ING, Maplewood, Nakagiri, and Transamerica Capital. Several commenters indicated that the proposed rule change should be made through notice and comment rulemaking with the Commission. As the Notice to Members stated, Section 19 of the Act requires that proposed rule changes such as IM-3060 be approved by the Commission following publication for public comment in the Federal Register. See Notice to Members 06-06, at 2 & n.2.

entertainment for employees of customers that is so frequent or excessive as to raise questions of propriety. Moreover, as discussed above, NASD is not seeking to regulate the behavior of the employees of a member's customers;¹⁵ rather, NASD is requiring members to develop and enforce some appropriate degree of limitation on the business entertainment its associated persons provide to its customers' employees. In achieving this end, both NASD and the NYSE believe that a general, principles-based approach is more appropriate than a restrictive, one-size-fits-all regulatory scheme. Given the significant variation in broker-dealer business models and size, and regional differences in what may be considered appropriate business entertainment, NASD concluded that a fixed-dollar standard or similar specific mandate would prove unworkable.

One commenter suggested that NASD exempt certain small broker-dealers, at least in part because they lack the resources to affect decision-making in the manner the IM seeks to prohibit and that such extravagant and extensive business entertainment is localized among larger firms and does not occur in rural or small-market areas.¹⁶ NASD staff disagrees with the contention that a small firm's business entertainment activities cannot influence the behavior of a customer's employee or that improper business entertainment is limited to large, urban areas. NASD believes that the proposed rule change should apply to all members, though each member may adopt written policies and

¹⁵ NASD recognizes that customers whose employees receive business entertainment have the responsibility to ensure that their employees do not engage in improper conduct. However, NASD believes that the person providing business entertainment cannot disclaim any responsibility for improper conduct that flows directly from business entertainment its employee provided when the employee either intended for the business entertainment to have that effect or could reasonably have judged that the business entertainment would be likely to have that effect.

¹⁶ Letter from Evolve.

procedures that reflect its specific business and practices. NASD expects and understands that there may be a wide variance among the policies and procedures firms adopt pursuant to this rule interpretation. Under the proposed rule change, a small firm is permitted to tailor its written policies and procedures governing business entertainment to reflect its particular business model and customer base.

Several commenters suggested that NASD identify in the IM the specific factors to be considered by firms in developing their written policies and procedures, such as those identified by the NYSE in its rule filing. NASD staff does not believe it is necessary to identify specific factors in the IM and that doing so may undermine the flexibility the proposed rule change is designed to achieve.¹⁷ In addition, NASD staff notes that the NYSE also has not chosen to put these criteria in its proposed rule, but rather intends to include them in an Information Memo to be released in conjunction with the approval of its proposed rule change. NASD staff will consider whether additional guidance concerning the IM is necessary when announcing the proposed rule change in a Notice to Members.

Several commenters expressed concern that the proposed rule change, including some of the defined terms, was too vague and may, in application, prove overly broad. Among other things, these commenters suggested that the proposed rule change could disadvantage firms with more conservative policies and procedures,¹⁸ effectively require pre-approval of all business entertainment,¹⁹ and could introduce disadvantages among

¹⁷ See Letter from BMA.

¹⁸ See, e.g., Letters from Hines and ING.

¹⁹ See Letter from Transamerica Capital.

different types of firms and other industry participants.²⁰ Other commenters believed that the principles-based approach proposed by NASD is the appropriate manner to address the needed clarification of business entertainment.

While NASD recognizes that there will be distinctions among each member's written policies and procedures, NASD concluded that member firms were in the best position to determine appropriate limitations and restrictions on the business entertainment provided by their associated persons. After considering the various comments concerning the definitions of "customer" and "business entertainment" in the proposed rule change,²¹ NASD has determined not to amend the definitions. While several commenters recommended that the definition of customer track the definition of "accredited investor" as defined in SEC Rule 501 under the Securities Act of 1933, NASD staff does not believe that the application of the IM should be dependent on any particular level of assets. While member firms may choose to treat certain types of customers or certain types of business entertainment differently for purposes of their written policies and procedures, NASD believes that, for purposes of the proposed rule change, a broad definition of each is appropriate.

With respect to one comment, NASD believes that it would be appropriate for a member's written policies and procedures to allow case-by-case review and approval for types of entertainment not specifically set forth in the member's policies and procedures.²² One commenter was concerned that a registered representative may not be

²⁰ See, e.g., Letters from Dominion and Seasongood.

²¹ See, e.g., Letters from BMA, Financial Network, FSI, ING, and Transamerica Capital.

²² See Letter from Debevoise.

aware whether a recipient of business entertainment is an employee of a customer of the firm.²³ If a person is entertained in his personal capacity as a natural person client, and the firm has information barriers that would prevent the person providing the business entertainment from knowing that the person represents another customer as an employee, and the person providing business entertainment has no knowledge that such person is an employee of a customer at the time of the business entertainment, then such entertainment would fall outside the scope of the IM.

Several commenters raised suggestions concerning Rule 3060's limitation on gifts and gratuities, ranging from comments focused on increasing the \$100 limitation, moving from a hard figure standard to a principles-based approach, and providing guidance on the types of gifts and incidental expenses that should be included or excluded from any limitation.²⁴ The proposed rule change is focused on business entertainment, which is excepted from the limitation on "gifts," and NASD is not currently considering amending the rule regarding gifts and gratuities.²⁵ NASD has long recognized that gifts – in contrast to business entertainment – are not incidental to the transaction of business. NASD requires that any gifts be de minimis and sees no reason to depart from this long-held view. NASD does not believe that the proposed rule change is the appropriate forum for providing interpretive advice on other aspects of Rule 3060; however, parties

²³ See Letter from FSI.

²⁴ See, e.g., Letters from ABASA, BMA, Debevoise, Evolve, Financial Network, and Wachovia.

²⁵ The one exception is the one noted above with respect to exigent circumstances. Numerous commenters requested that NASD adopt the exigent circumstances exception from the gift rule similar to the exception that the NYSE has proposed. See, e.g., Letters from ABASA, BMA, and Wachovia. As discussed above, NASD has determined that it is appropriate to provide for such an exception.

seeking interpretive guidance concerning the \$100 limitation on gifts and gratuities can submit an interpretive letter to the NASD staff in the Office of General Counsel.

One commenter expressed concern that the IM shifts the burden of proof required under Rule 3060 and suggested that any change to Rule 3060 be done through a separate rule proposal rather than through an IM. As discussed in footnote 14, the IM, which is the equivalent of a rule change, is being proposed in accordance with the procedures for a proposed rule change under Section 19 of the Act. NASD has chosen for narrative stylistic purposes to designate this proposed rule change as interpretive material. Rule 3060 and IM-3060 are two separate provisions, and the burden of proof under Rule 3060 is not affected by the proposed rule change.

Several commenters appeared concerned that the discussion in footnote five of the Notice would prohibit entertaining friends and relatives. This misconstrues the meaning of footnote five, which says: “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.” What is required by footnote five is that an associated person not avoid the application of the firm’s business entertainment policies by claiming such entertainment is “personal” rather than business. Firms are, however, likely to include policies in their business entertainment procedures to address personal entertainment of employees of a customer where there is a family or some other personal relationship, much the way firms do today for gifts and gratuities under Rule 3060.

Many commenters requested clarification on whether an “independent” review could be conducted by an independent department within, or affiliated with, the member.²⁶ As noted above, NASD believes that an independent department or business unit within, or affiliated with, a member would be independent within the meaning of the term in the proposed rule change. The ICI also suggested that the frequency of the reviews be left within the discretion of the individual member. NASD agrees that it is appropriate to leave the issue of frequency of the reviews to the individual member firm; however, NASD notes that the member’s written policies and procedures should address the frequency of the reviews and should, in general, provide for a specific frequency (e.g., quarterly, annually, etc.).

Many commenters expressed concern with the breadth of the recordkeeping requirement and requested a lengthy implementation time for the recordkeeping requirements.²⁷ In response to these comments, NASD provided an exception from the recordkeeping obligations for expenses of \$50 or less. However, as discussed above, NASD believes that a member’s policies and procedures should prevent associated persons from intentionally avoiding the \$50 requirement by breaking up what are otherwise connected costs or by engaging in frequent, repeated business entertainment at amounts below the \$50 threshold. For example, a firm’s policies and procedures may require associated persons to submit all business entertainment expenses for review; however, the firm may decide to record and track only amounts over \$50. NASD is also

²⁶ See, e.g., Letters from Debevoise, Evolve, ICI, KBW, NRS, Transamerica Capital, and Wachovia.

²⁷ See, e.g., Letters from Evolve, Financial Network, FSI, H.D. Vest, ICI, ING, Maplewood, and Transamerica Capital.

providing for an effective date of one year following NASD's publication of a Notice to Members announcing the Commission's approval of the proposed rule change. NASD believes that one year will allow members sufficient time to implement recordkeeping systems to comply with the proposed rule change.

In response to a comment from Debevoise, NASD has amended one of the examples in the proposed rule change to reflect that firms may choose to require approval from "appropriate supervisory or compliance personnel" rather than "senior management." While the commenter noted that the surrounding language was not intended to be prescriptive, NASD concluded that a broader term was appropriate in this context. As the proposed rule change notes, the supervisory procedures a member adopts are within the discretion of each member; however, the procedures should recognize that supervision is a critical component of any written policies and procedures and should be reasonably designed to comport with the principles stated in the proposed rule change.

One commenter suggested that NASD permit a member's procedures to include prompt review of business entertainment after the event.²⁸ The commenter offered an example of a dinner that unexpectedly exceeds the firm's threshold. NASD does not believe that a member's policies and procedures should allow for post-event approval because there does not appear to be an effective means of rescinding business entertainment that has already been provided. Rather, associated persons who are concerned that the cost of an event may exceed the threshold should request approval in advance to go over the firm's limit. In such a situation, the member should impose another dollar limit rather than simply waive the requirement.

²⁸ See Letter from T. Rowe Price.

Finally, several commenters requested that NASD and NYSE harmonize their proposed rule changes or, in the alternative, include a provision that a dual member that complies with one of the SRO's rule will be deemed to be in compliance with the other SRO's rule.²⁹ In response to these comments, NASD has sought to address substantive disparities between its rule and that of the NYSE.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or

²⁹ See, e.g., Letters from BMA and SIA.

- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-NASD-2006-044 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASD-2006-044. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing also will be available for inspection and copying at the principal office of NASD.

All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NASD-2006-044 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.³⁰

Nancy M. Morris

Secretary

³⁰ 17 CFR 200.30-3(a)(12).