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February 23, 2006

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

Re: Proposed IM-3060 (Gifts and Business Entertainment)

Dear Ms. Sweeney:

On behalf of H.D. Vest Investment Services ("H.D. Vest"), I would like to thank the NASD for the opportunity to comment on the proposed Interpretive Material (IM-3060) concerning gifts and business entertainment (the "Proposal"). H.D. Vest is a registered broker-dealer with over 5,000 registered representatives. Our representatives work with many clients who are small and medium businesses, and would therefore be significantly impacted by the new regulations. Because the accounts associated with these businesses are typically smaller in size, they are often underserved by larger firms.

At the outset, I would like to commend NASD for providing an opportunity for comment on the Proposal. The Proposal represents a significant departure from the current approach to regulating issues concerning business gifts and entertainment. From a practical standpoint, the Proposal is more akin to a new rule rather than an interpretation of the existing rule. It would significantly increase the costs associated with regulation in this area. Accordingly, notice and comment is the appropriate approach.

We have several issues with the rule which will be discussed in this comment letter. First, it is not apparent from Notice to Members 06-06 ("NTM") that there is a need for additional regulation. Before adopting the Proposal, NASD should examine and provide the underlying basis for imposing significant additional regulatory burdens in this area. Second, the rule does not provide clear standards for compliance, and will result in uneven application in practice. Finally, there are interpretive issues and costs associated with certain requirements such that those requirements should be eliminated or, alternatively, less costly approaches should be considered.

I. There is No Apparent Need for Additional Costly Regulation

Before adopting a new approach that will significantly increase the costs of compliance, we believe NASD should examine and provide additional information concerning the scope of the underlying issue, and analyze the costs the Proposal would impose on the industry. The NTM provides very limited information regarding the underlying basis for the Proposal. In this regard, the NTM states only that the Proposal was published "[i]n light of recent events."

A. The Proposal Does Not Identify Evidence of Pervasive Abuse

There have been reports in the media recently concerning gifts being given by broker-dealers to business clients. Although these events received a lot of media attention, they do not necessarily support the conclusion that there is widespread abuse. It is difficult to comment specifically on the Proposal in terms of costs versus benefits without knowing the scope of the underlying problem. The following questions, among others, are pertinent to whether a new approach is warranted:

- How widespread are the perceived abuses – do they affect 1 percent of the industry, 50 percent, 100 percent?
- Are perceived abuses limited to: (i) a particular type of firm?; (ii) a particular size firm?; or (iii) firms that engage in a particular line of business?
- Did the perceived abuses involve customers of a certain size or in a certain industry?

The answers should dictate the nature and scope of any regulatory response. Accordingly, NASD should not adopt new regulations until it has gathered additional information about the underlying problem it is trying to solve.

B. Any Past Abuses Are Already Prohibited Under Existing Rules

Too often the regulatory reaction to abuses – especially abuses that receive a lot of media attention – is to adopt new rules. The premise seems to be that violations would only occur if the current rules were inadequate, and that new rules are therefore required. To the contrary, abuses are more often the product of people flouting the rules, rather than a shortcoming in the rules themselves. NASD already has an avenue for pursuing violators, and should not impose additional rules on the entire industry just because there is a perceived need to "do something."

Every new rule leads to many new and costly requirements that often are of marginal utility in terms of protecting investors. When rules are not clear in their mandate, they result in additional compliance and legal costs, and often result in unintended consequences. Individually, and cumulatively over time, these marginally useful rules actually harm investors by increasing the costs that necessarily are passed on to them, and by diverting limited resources away from more meaningful pursuits.

The "recent events" that spawned the Proposal appear to be already prohibited under existing rules. If NASD is able to prosecute offenders under existing regulations, it is fair to question why new rules are needed at all. It is counter-productive to impose costly new requirements that in essence punish an entire industry based on the transgressions of a few.

Indeed, the current rule is by its terms already very restrictive, even allowing for the 1999 interpretive letter permitting "ordinary and usual business entertainment." Abuses of the kind that apparently concern NASD appear to be prohibited under the existing regulatory regime. This strongly suggests that to the extent change is necessary it should be incremental, rather than the proposed wholesale change with extensive compliance, record-keeping and supervisory requirements.

C. Additional Regulation is Also Unnecessary Because the Clients the Proposal Purports to Protect are Capable of Protecting Themselves

In looking at the value of rules governing business gifts and entertainment – and whether additional regulations are necessary – it is also important to recognize that there are also restrictions on company employees who are on the receiving end of gifts and entertainment. Unlike many of the sales practice rules that have been adopted to protect individual investors, the "customers" the Proposal seeks to protect are companies that are already fully empowered to monitor this type of activity. Because most businesses, by reason of their market power, already wield a high degree of control over how they award business to vendors, the need for regulatory paternalism or costly "prophylactic" rules is greatly reduced.

For example, many companies (including most if not all that are public or are seeking to go public) have adopted codes of ethics for directors, officers and employees. Many of these codes of ethics prohibit *company employees* from engaging in the type of conduct that is also prohibited by Rule 3060. A company can prohibit its employees from accepting *any* gifts or entertainment from potential vendors, and discharge employees who violate the rule. In this regard, it is likely that the employees involved in the "recent events" from the client side of the transaction lost their jobs and future income, or suffered other penalties at the hands of their employer. That is a strong market-based incentive system to address the issue.

In addition, depending on their responsibilities, company officers or employees who use company resources to obtain personal benefit might be violating their fiduciary duties to the company and its owners. Thus, even if the company's code of ethics does not specifically prohibit conduct, the employee might be subject to civil (or even criminal) proceedings for accepting inappropriate business gifts or entertainment. The threat of litigation and punishment – which has been realized in the "spinning" prosecutions – also provides a strong market-based incentive to prevent inappropriate activity in this area from recurring.

If companies are concerned about the corrupting influence of business entertainment, they also have the ability to regulate the conduct of firms with which they do business. Companies can prohibit broker-dealers from providing entertainment or gifts to employees in connection with soliciting business, or place appropriate restrictions on those activities. They also have the ability to demand, at any time, any information or disclosure they feel is necessary regarding the business entertainment firms have provided to their employees. Broker-dealers that fail to comply with company rules

would take themselves out of contention for actually obtaining the business. This is, again, a strong market-based incentive.

Accordingly, under the current regulatory regime, there are already significant legal and market-based restrictions on both the *giving* and *receiving* of inappropriate business gifts or entertainment. The NASD has already imposed significant restrictions that registered representatives must abide by or risk enforcement proceedings. On the other hand, company officers – with oversight by directors who owe fiduciary duties to the owners – are unquestionably in the best position to determine the potential corrupting influence of business entertainment offered to their employees, and the appropriate restrictions on allowing employees to accept gifts or entertainment from vendors.

There is an old maxim that you cannot legislate ethics. Especially in the aftermath of high profile abuses, market forces tend to regulate ethical issues such as those that are implicated by the restrictions on business gifts and entertainment. Before adopting new requirements, NASD should examine whether practices have, in fact, changed since the recent events came to light. The companies and broker-dealers that were engaged in improper behavior most likely have already taken steps to help prevent abuses from recurring. Other firms have also likely reviewed their procedures to ensure that they are in compliance. The negative publicity arising out of the "recent events," coupled with regulatory sanctions, will do more to mitigate inappropriate behavior than the Proposal could ever hope to accomplish.

II. The Proposed Requirements Do Not Provide Clear Standards and Will Lead to Uneven Application in Practice

The Proposal would require that firms adopt procedures that "determine and define forms of business entertainment that are appropriate and inappropriate, include 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." The NTM notes that the Proposal "does not impose hard limits, nor does it require that all members adopt the same limits or even treat all recipients equally." It further states, on the other hand, that the "policies and procedures must not be so unbounded or vague that no reasonable determination of propriety can be discerned."

While the Proposal ostensibly provides the benefit of flexibility, it does so at the expense of providing clear guidance as to what is required to comply. As the Proposal implicitly recognizes, the challenge in trying to adopt specific procedures in this area is that the "ordinary and usual" business practices surrounding business entertainment vary depending on the context. The conventions and appropriate limitations on business entertainment will depend, among other things, on: (a) the particular characteristics of the company; (b) the industry in which the company operates; (c) the size of the company; (d) the level of the individual within the company with whom the broker-dealer is dealing; (e) the specific area of responsibility of the employee who is receiving business entertainment; (f) the company's own limitations as specified in its internal

policies on business entertainment; (g) the size of the broker-dealer; (h) the line of business within the broker-dealer that is providing the business entertainment; (i) the level of the individual within the broker-dealer who is providing the entertainment; and (j) regulatory requirements outside of the securities laws.

The above list is not exhaustive, but it does demonstrate the difficulty of trying to design policies to govern all possible circumstances. Presumably, this difficulty is why NASD itself took the more general approach to regulation in the first place, and is a principal reason why the Proposal does not provide more specific guidance concerning practices that should be limited or eliminated. We are not suggesting that NASD should adopt specific prohibitions on business entertainment; however, if NASD believes additional restrictions are called for, the Proposal should set clear standards that firms can comply with consistently across the board.

III. Comments on Specific Provisions

A. The Proposal Does Not Make Clear Whether it Uses an Existing Standard or Adopts a New One

The Proposal requires that firms adopt procedures that "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." Rules 2110 and 3060 already contain a mandate that presumably is broad enough to encompass the sort of conduct contemplated by the Proposal. Adding another ambiguous requirement on top of the existing one does not advance the goals of clear and efficient regulation, and will result in additional and unnecessary costs as firms attempt to interpret the new requirements.

Furthermore, the guidance provided in the NTM may actually serve to confuse the interpretive issues that are likely to arise out of the Proposal. The explanatory commentary in the NTM states that: "A member's policies and procedures should preclude providing business entertainment that is so lavish or extensive in nature that an employee would likely feel compelled to act in a manner inconsistent with the interests of his or her employer...." This appears to be a reformulation of the current requirement that entertainment not be "so frequent nor so extensive as to raise questions of propriety." However, it is not clear whether NASD, by using a new formulation, intends to impose a new standard. If that is the case, NASD should make clear that a new meaning is intended, clearly explain how the new standard is different from the old one, and provide guidance on how the new standard should be implemented in practice.

B. Proposed Record-Keeping Requirements are Onerous and Redundant

The Proposal would require that firms "maintain detailed records of business entertainment expenses." There will be extensive costs associated with documenting and supervising every instance of business entertainment. The stated justification for imposing this requirement is to "allow a customer to verify and review the types of

business entertainment received by its employees . . . ." The substantial costs associated with this requirement are not justified where: (1) detailed records would be required in each and every instance, even though there is no indication that the information would be of interest to customers; and (2) as noted above, those companies that are interested in obtaining this information are already fully capable of requesting or requiring it as a condition for doing business, even in the absence of any rules.

H.D. Vest estimates that it has approximately 120,000 business accounts. This means that if each client is entertained only once each year, the firm would have to track, on average, approximately 470 items of business entertainment *each day* (based on 255 business days per year). Most of those items will be meaningless in terms of the dollar amounts involved and the concerns the Proposal hopes to address. If NASD decides to go forward with the Proposal, it should include provisions to reduce this unnecessary burden. Among the options that should be considered are exemptions where the amounts involved are unlikely to have an improper influence, or where the characteristics of the company make it unlikely that the activities of an employee would be undetected. For example: (a) entertainment under a certain amount annually (*e.g.*, $500 per person); and (b) closely held companies, or companies with fewer than 75 employees. In order to gather additional information, NASD should re-publish a new proposal seeking comment specifically on these issues and other alternative approaches.

Conclusion

As presented, the need for additional regulation is not apparent, and the Proposal would result in significant additional costs, unintended consequences, and only marginal benefit. To the extent there have been abuses, they can be addressed under current rules and through guidance rather than additional supervisory and record-keeping requirements. NASD should not adopt the Proposal without a thorough analysis of the costs and benefits associated with the new requirements.

Sincerely,

Brian A. Stern
General Counsel