

MEMO# 21171

May 25, 2007

NASD and NYSE Proposals Relating to Business Entertainment

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 28-07
EQUITY MARKETS ADVISORY COMMITTEE No. 30-07
INVESTMENT ADVISER MEMBERS No. 15-07
COMPLIANCE MEMBERS No. 19-07
SEC RULES MEMBERS No. 53-07
SMALL FUNDS MEMBERS No. 32-07 RE: NASD AND NYSE PROPOSALS RELATING TO
BUSINESS ENTERTAINMENT

The Securities and Exchange Commission has published for comment proposed rule changes filed by NASD [\[1\]](#) and the NYSE [\[2\]](#) addressing the business entertainment practices of member firms. Both proposals would require member firms to more clearly outline the policies and procedures a member must adopt in connection with providing business entertainment to representatives of customers or prospective customers. The proposals, which are substantially similar except as noted, are discussed further below.

Overview of NASD and NYSE Proposed Rule Changes

NASD Rule 3060 [\[3\]](#) and NYSE Rule 350 generally prohibit any member or person associated with a member firm from giving, directly or indirectly, 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. NASD is proposing Interpretive Material ("IM") to NASD Rule 3060 and the NYSE is proposing new Rule 350A to address conflicts of interest in connection with business entertainment.

The NASD and NYSE proposals provide guidance concerning the written policies and procedures that members must adopt surrounding their business entertainment practices. The proposals, which take a principle-based approach with flexible prescriptive elements and guidelines, require members to determine and define the forms of business entertainment that are appropriate and inappropriate using quantitative and/or qualitative

standards that address the nature and frequency of the entertainment provided, as well as the types and class of any accommodations or transportation. The proposals also require members to impose specific dollar limits or thresholds requiring advance written approval. [4] Under the proposals, each member must specify the methodology to be used by the member to calculate the value of the business entertainment. In general, business entertainment expenses should be valued at the higher of face value or cost to the member. The proposals also expressly allow members to set different standards for business entertainment in connection with events that are educational, charitable or philanthropic in nature.

The proposals require that members' policies and procedures include procedures designed to detect and prevent business entertainment that is intended as, or could reasonably be perceived to be intended as, an improper quid pro quo or that could otherwise give rise to a potential conflict of interest. In addition, written policies and procedures must provide for effective supervision and appropriate education and training to all personnel who supervise, administer, or are subject to the written policies and procedures prescribed by the rules. Finally, members must maintain detailed records of business entertainment expenses and make such information available to the customer with respect to its customer representatives upon written request. The proposals would provide an exception from the recordkeeping requirements for expenses under \$50 and a limited exemption from certain of the proposed rules' provisions for members whose business entertainment expenses in the course of their fiscal year are below \$7,500.

The proposals define the terms "customer," "customer representative," and "business entertainment" for purposes of the rules. Under the proposals, the definition of "customer" recognizes the proposed distinction between business entertainment provided directly to natural persons (which is not covered by the proposed rules) and business entertainment provided to customer representatives (which is covered by the proposed rules). [5] The definition of "business entertainment" also clarifies that, absent exigent circumstances, a member must accompany or participate in an event for it to be deemed business entertainment. [6]

NASD and the NYSE have requested an effective date of six months following the Commission's approval of the proposed rule changes in order to give membership sufficient time to upgrade systems and develop procedures to effectively comply with the rules' requirements.

Proposed NASD IM-3060's Applicability to Non-Cash Compensation Rules 2820 and 2830

The proposed IM clarifies that the interpretation does not apply to any non-cash compensation that falls within NASD Rule 2820(g) or Rule 2830(l) (i.e., business entertainment expenses of member firms related to the sale and distribution of variable contracts and investment company securities). This point was unclear from the original proposed IM and accompanying Notice to Members. [7]

Proposed NYSE 350A Notice Requirement and Information Memo

Proposed NYSE 350A includes a requirement that each member must have a system in place to give notice (e.g., via the member's website, a disclosure document, or other appropriate means) to customers that utilize customer representatives subject to this rule

that, upon a customer's written request, the member will promptly provide detailed information regarding any business entertainment provided to their customer representative(s) by the member. The NYSE Release notes that the notice provision would encourage the expansion of monitoring and controls on business entertainment beyond broker-dealers to the employers of business entertainment recipients. The NASD Release requests comment on whether NASD should have a similar notification provision for customers utilizing customer representatives.

The NYSE Release also states that it intends to publish an Information Memo to be released in conjunction with its final rule that will provide a list of factors that members must consider in formulating criteria to evaluate the propriety of business entertainment. In contrast, the NASD Release notes that 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. It also says that NASD staff will consider whether additional guidance concerning the IM is necessary when announcing the proposed rule change in a Notice to Members.

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endnotes

[1] Securities Exchange Act Release No. 55765 (May 15, 2007), 72 FR 28743 (May 22, 2007) ("NASD Release"). The NASD Release can be found on the SEC's website at <http://sec.gov/rules/sro/nasd/2007/34-55765.pdf>. Comments on the proposed rule change must be received by the SEC no later than June 12, 2007. The proposed rule change was originally published for comment in NASD Notice to Members 06-06 (January 2006), which is available on the NASD's website at http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_015876.pdf. At that time, the Institute submitted a comment letter that focused on clarifying certain issues relating to compliance with the new policies and procedures under the proposed rule change. See [Memorandum](#) to Closed-End Investment Company Members No. 8-06, Equity Markets Advisory Committee No. 6-06, Investment Adviser Members No. 9-06, Compliance Members No. 12-06, SEC Rules Members No. 21-06, and Small Funds Members No. 17-06, dated February 24, 2006 [19777].

[2] Securities Exchange Act Release No. 55766 (May 15, 2007), 72 FR 28534 (May 21, 2007) ("NYSE Release"). The NYSE Release can be found on the SEC's website at <http://sec.gov/rules/sro/nyse/2007/34-55766.pdf>. Comments on the proposed rule change must be received by the SEC no later than June 11, 2007.

[3] In 1999, NASD issued a staff letter clarifying that Rule 3060 does not prohibit "ordinary and usual business entertainment" provided that such entertainment is "neither so frequent nor so extensive as to raise any question of propriety." According to the NASD Release, the proposed rule change would supersede any prior guidance of NASD staff regarding business entertainment under Rule 3060, including the 1999 letter.

[4] The proposals do not impose specific limits, nor do they require that all members adopt the same limits or treat all recipients equally. The NYSE Release notes that this approach would have the benefit of establishing unambiguous standards, encourage self-comparison of such standards among firms of similar size and circumstance, and, in conjunction with feedback from regulatory organizations, likely result in the establishment of "unofficial," but

generally accepted industry standards over time.

[5] “Customer” would be defined under proposed NYSE Rule 350A as a “person that maintains a business relationship with a member organization via the maintenance of an account, through the conduct of investment banking, or pursuant to other securities-related activity” or “a person whose customer representative receives business entertainment for the purpose of encouraging such person to establish a business relationship with a member organization by opening an account with the member organization or by conducting investment banking or other securities-related activity with the member organization.” The definition of “customer” under proposed NASD IM-3060 is substantially similar. “Customer representative” under both proposals would be defined as a “person who is an employee, officer, director, or agent of a customer, unless such person is a family member of the customer.”

[6] “Business entertainment” would be defined under proposed NYSE Rule 350A to include “any social event, hospitality event, sporting event, entertainment event, meal, leisure activity, or event of like nature or purpose, including business entertainment offered in connection with a charitable event, educational event or business conference, as well as any transportation or lodging related to such activity or event, in which a person associated with a member organization accompanies a customer representative.” The definition of “business entertainment” under proposed NASD IM-3060 is substantially similar.

[7] See Investment Company Institute Letter from Ari Burstein, Associate Counsel, to Barbara Z. Sweeney, Office of the Corporate Secretary, NASD, dated February 23, 2006.