

COMMENT LETTER

February 23, 2006

Institute Letter on NASD Proposal Relating to Business Entertainment Expenses (pdf)

February 23, 2006 Ms. Barbara Z. Sweeney Office of the Corporate Secretary NASD 1735 K Street, N.W. Washington, D.C. 20006-1506 Re: NASD Proposed Interpretive Material 3060

Dear Ms. Sweeney: The Investment Company Institute¹ supports NASD's proposed Interpretive Material ("IM") on NASD Rule 3060 addressing business entertainment practices of member firms.² Increased guidance in this area is appropriate given the potential conflicts of interest raised by gifts and other benefits provided to employees of entities that use the services of NASD member firms. As discussed in more detail below, the Institute's comments focus on clarifying certain issues relating to compliance with the new policies and procedures under the proposed IM. Proposed IM's Applicability to Mutual Fund Distributors and Wholesalers The restrictions on business entertainment under Rule 3060 and the proposed IM closely resemble those provided under NASD Rule 2830. Rule 2830 addresses business entertainment expenses of member firms related to the sale and distribution of investment company securities, i.e., where an NASD member that is a mutual fund distributor or wholesaler entertains the representatives of financial intermediaries who sell shares of the fund.³ The proposed IM notes that the current

1 The Investment Company Institute is the national association of the U.S. investment company industry. More information about the Institute is available at the end of this letter. 2 NASD Notice to Members 06-06 (January 2006). 3 Specifically, Rule 2830(l)(5) prohibits the payment of any non-cash compensation except under certain specified arrangements, such as where the entertainment is "neither so frequent nor so extensive as to raise any questions of propriety and is not preconditioned on achievement of a sales target." NASD Rule 2820 applies in lieu of Rule 2830 in connection with the sale and distribution of variable contracts. Our comments on the relationship between NASD Rules 2830 and 3060 apply equally to the relationship between Rules 2820 and 3060. Ms. Barbara Z. Sweeney February 23, 2006 Page 2 of 5 interpretive position on Rule 3060⁴ was based in part on the restrictions on "non-cash compensation" in Rule 2830 but does not discuss any further the relationship between the two rules. Although both rules (and interpretations of those rules) use similar language to delineate when business entertainment would be permitted, the proposed IM appears to be designed to address situations distinct from those governed by Rule 2830. While Rule 2830 typically addresses situations in which a member firm entertains the representatives of another member firm, the proposed IM focuses on situations where an NASD member is providing professional services to a "customer" and is using business entertainment to promote those services.⁵ As the Notice to Members states, a typical situation covered by Rule 3060 would be entertainment provided by an NASD

member to portfolio traders of a mutual fund customer for the purpose of generating business relating to the execution of the fund's securities transactions through the member. It is unclear from the proposed IM and accompanying Notice to Members whether NASD intends for the proposed IM to cover situations involving business entertainment expenses related to the sale and distribution of investment company securities. Arguably, a financial intermediary dealing with an NASD member that is a mutual fund distributor or wholesaler could be considered a "customer" of the member, as that term is broadly defined in the proposed IM. The Institute believes that such a situation should not be covered by the IM, and is concerned that applying the IM to situations already covered by Rule 2830 would create overlapping and, to an extent, inconsistent regulation of member firms' business entertainment practices. This, in turn, could lead to confusion on the part of NASD members subject to Rule 2830 and interfere with members' efforts to ensure compliance with the terms and conditions of the rule. We recommend that NASD clarify that the proposed IM does not address situations already covered under Rule 2830 and does not supersede any interpretive guidance under that rule. If NASD believes that both Rule 2830 and the proposed IM apply in this context, we recommend that, at the very least, conforming amendments be proposed to Rule 2830 to prevent confusion on the part of NASD members. 4 See Letter to Henry H. Hopkins and Sarah McCafferty, T. Rowe Price Investment Services, Inc., from R. Clark Hooper, NASD, dated June 10, 1999. 5 The term "customer" is broadly defined under the proposed IM 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, agent or representative act on behalf of the account in some capacity in respect of such account or customer relationship with the member." Ms. Barbara Z. Sweeney February 23, 2006 Page 3 of 5 Clarification of Proposed Policies and Procedures The Institute has several technical comments on the proposed IM. Most significantly, we believe that further NASD guidance is necessary in several areas of the proposed policies and procedures.

Monitoring of Compliance with Policies and Procedures The proposed IM states that there should be periodic monitoring of compliance with the policies and procedures and that, when practicable, such monitoring should be conducted by an "independent reviewer." The Institute recommends that NASD clarify that personnel within a member firm are eligible to conduct the independent review of compliance with policies and procedures (as opposed to having to employ an outside party). Such personnel should be required to be independent of any functions related to business entertainment practices. Requiring that such a review be conducted by a person outside of the member firm could considerably raise costs of complying with the proposed IM without providing any apparent additional benefits. In addition, a member should be provided with flexibility to determine when a review may be necessary and how often such a review should occur, as each member's situation will differ depending on, for example, its size or amount of business entertainment expenses.

Personnel Designated to Supervise, Approve and Document Expenses The proposed IM states that members' policies and procedures must "establish standards to ensure that persons designated to supervise, approve and document business entertainment expenses are sufficiently qualified." It is unclear from the proposed IM at what level such persons become "sufficiently qualified" to perform the required functions. To avoid any confusion in the application of this requirement, the Institute recommends that NASD provide more specific guidance on factors that should be considered in making this determination and clarify that members have sufficient flexibility in applying those factors.

Recordkeeping Requirements The proposed IM requires that members must maintain "detailed" records of the nature and expense of business entertainment but is unclear what such "detailed" records would include. The Institute recommends that NASD

provide guidance on the scope of records necessary under this requirement. In addition, our members report that, depending on the scope of the records that must be kept, considerable changes to their current recordkeeping systems may be necessary to comply with the proposed recordkeeping requirements. To allow firms to establish and/or modify the necessary recordkeeping systems, we recommend that NASD provide a sufficient transition period for the proposed IM to become effective, e.g., 12 months. Ms. Barbara Z. Sweeney February 23, 2006 Page 4 of 5 Training and Education of Personnel The proposed IM requires that members have written policies and procedures that, among other things, "require appropriate training and education to all applicable personnel." [emphasis added]. The Notice to Members describing the proposed IM states that members "should oversee the training and education of all personnel." [emphasis added]. Given the inconsistency in this language, the Institute requests that NASD clarify that this requirement relates only to "applicable" personnel, e.g., those personnel whose positions involve business entertainment expenses. Such a clarification would ensure that training and education in this area is focused on those persons for whom it is relevant. * * * * *

The Institute appreciates the opportunity to comment on this important initiative. If you have any questions regarding our comments, please contact the undersigned at 202-371-5408.

Sincerely, /s/ Ari Burstein Ari Burstein Associate Counsel cc: Gary L. Goldsholle, Associate Vice President and Associate General Counsel Office of General Counsel NASD Regulatory Policy and Oversight Thomas A. Selman, Senior Vice President Joseph P. Savage, Associate Vice President Investment Companies Regulation, NASD Robert L. D. Colby, Acting Director Division of Market Regulation U.S. Securities and Exchange Commission Susan Ferris Wyderko, Acting Director Division of Investment Management U.S. Securities and Exchange Commission Ms. Barbara Z. Sweeney February 23, 2006 Page 5 of 5 * * * * *

About the Investment Company Institute The Investment Company Institute's membership includes 8,554 open-end investment companies ("mutual funds"), 654 closed-end investment companies, 162 exchange-traded funds and 5 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately \$8.802 trillion (representing 98 percent of all assets of US mutual funds); these funds serve approximately 89.5 million shareholders in more than 52.6 million households.