



VOICE OF THE INDEPENDENT CONTRACTOR BROKER-DEALER

June 12, 2007

VIA ELECTRONIC MAIL

Nancy M. Morris  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

RE: File Number SR-NASD-2006-044

Dear Ms. Morris:

On May 3, 2007, the National Association of Securities Dealers, Inc. (NASD) filed its amended proposal with the SEC to adopt new Interpretative Material to NASD Conduct Rule 3060 (Proposal).<sup>1</sup> The Proposal is intended to clarify broker-dealer firms' existing obligations with respect to the provision of business entertainment and to help prevent conduct by associated persons that could undermine the performance of an employee's duty to the member's customer. The NASD's Proposal would require member firms to adopt policies and procedures addressing business entertainment. These procedures would define appropriate and inappropriate forms of business entertainment, serve to detect and prevent business entertainment perceived or intended to compel an employee to act in a manner inconsistent with the interests of his employer, establish qualification standards for supervisors, and provide for appropriate training and education of all relevant personnel. The Financial Services Institute<sup>2</sup> (FSI) appreciates this opportunity to comment on the Proposal.

#### Background on FSI Members and their Customer Relationships

The IBD community has been an important and active part of the lives of American consumers for more than 30 years. The IBD business model focuses on comprehensive financial planning services and unbiased investment advice with little, if any, proprietary product bias,<sup>3</sup> while avoiding some of the pitfalls to which other financial service business channels have been susceptible in recent years. IBD members also share a number of other similar business characteristics. They generally clear their securities business on a fully disclosed basis; primarily engage in the sale of packaged products, such as mutual funds and variable insurance products, by "check and application"; take a comprehensive approach to their clients' financial goals and

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<sup>1</sup> See SEC Release Nos.: 34-55765, File No.: SR-NASD-2006-044 (May 22, 2007).

<sup>2</sup> The Financial Services Institute, Voice of Independent Broker-Dealers and Independent Financial Advisors, was formed in 2004. Our members are broker-dealers, often dually registered as federal investment advisers, and their independent contractor registered representatives. FSI's 110 Broker-Dealer members have more than 130,000 registered representatives serving more than 14 million American households and generating in excess of \$13.7 billion in annual revenues. FSI also has more than 7,800 Financial Advisor members.

<sup>3</sup> Please note that there are some large independent broker-dealer firms who offer proprietary products such as mutual fund, variable annuity, and/or investment advisor products offered by an affiliated or parent insurance company, broker-dealer or investment advisor. Nevertheless, these IBD firms, and their proprietary products, represent the exception to the rule.

objectives; and provide investment advisory services through either affiliated registered investment advisor firms or such firms owned by their registered representatives. Due to their unique business model, IBDs and their affiliated financial advisors are especially well positioned to provide middle class Americans with the financial advice, products, and services necessary to achieve their financial goals and objectives.

In the U.S., approximately 105,000 independent financial advisors – or approximately 20 percent of all registered representatives – practice in the IBD channel.<sup>4</sup> These financial advisors are independent contractors, rather than employees of the IBD firms. These advisors are entrepreneurial business owners who typically have strong ties, visibility, and individual name recognition within their communities, know their clients personally, and provide investment advice in face-to-face meetings – often times over the client’s kitchen table. Most new clients come through referrals from existing clients or other centers of influence. Due to their close ties to the community in which they operate their small businesses, we believe these financial advisors have a strong incentive to make the achievement of their clients’ investment objectives their primary goal.

Independent financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans with financial education, planning, implementation, and investment monitoring. Clients of independent financial advisors are typically “main street America” – it is, in fact, almost part of the “charter” of the independent channel. The core market of advisors affiliated with IBDs is clients with a net worth of \$250,000 to \$1 million.<sup>5</sup> This account size can not support lavish business entertainment expenditures. Accordingly, IBD firms do not provide their affiliated financial advisors with expense accounts and do not have the infrastructure necessary to track such expenses. As independent contractors, independent financial advisors bear the full cost of any business entertainment they provide.

The Proposal is of particular interest to FSI and our members due to its expected impact. While the Proposal represents an improvement over the NASD’s initial draft<sup>6</sup>, it remains overly broad, unduly burdensome, and unjustified in light of its expected costs and benefits. If adopted, the Proposal would harm IBDs, financial advisors, and their customers by consuming resources that could be used to improve customer service, develop innovative solutions to investor needs, or facilitate IBD firms’ efforts to operate more effectively and efficiently. The unfortunate but all too predictable result is that the burden of these unnecessary costs will be borne by the investing public. Therefore, FSI strongly urges the SEC and NASD to amend their proposal as outlined below or to maintain the status quo by allowing the staff interpretation that has guided member’s use of business entertainment since 1999 to remain in place. FSI offers a detailed discussion of its concerns below.

#### Detailed Comments on the Proposal

FSI respectfully provides the following comments for consideration by the NASD and SEC prior to adoption of IM-3060:

1. Proposal’s Benefits are Outweighed by its Costs – In January of 2006, the NASD released

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<sup>4</sup> Cerulli Associates, “Trends in the IBD Marketplace,” December 2004. Please note that this figure represents a conservative estimate of independent financial advisors. In fact, more than 130,000 financial advisors are affiliated with FSI member firms.

<sup>5</sup> Ibid.

<sup>6</sup> NASD Notice to Members 06-06. See at [http://www.nasd.com/RulesRegulation/NoticestoMembers/2006NoticestoMembers/NASDW\\_015877](http://www.nasd.com/RulesRegulation/NoticestoMembers/2006NoticestoMembers/NASDW_015877).

Notice to Members 06-06 (NtM 06-06). NtM 06-06 cited "recent events" as the basis for proposing IM-3060 to "more explicitly outline the policies and procedures that a member must adopt in connection with its business entertainment practices."<sup>7</sup> These recent events included the NASD's December 4, 2006 announcement that it had fined Jefferies & Company, Inc. \$5.5 million for providing more than \$1.6 million in improper gifts and entertainment to equity traders employed by FMR Co., Inc., an investment advisor to the Fidelity family of mutual funds.<sup>8</sup> As clear violations of existing NASD guidance on business entertainment, these activities were deserving of regulatory enforcement action. However, FSI believes that the current Proposal uses this enforcement action as justification for imposing a regulatory scheme whose modest benefits are greatly outweighed by the substantial costs that will be imposed by its implementation.

Unfortunately, the Proposal unwittingly places the greatest burden on those firms who are least likely to commit the offenses that it is designed to address. The large Wall Street firms who aggressively compete for institutional business have both the financial incentive to engage in extensive business entertainment and the resources to establish the compliance and recordkeeping systems necessary to comply with the Proposal. In fact, these firms already have "procedures and systems designed to document, review and approve firm-related gift, travel and entertainment expenses."<sup>9</sup> However, the typical IBD firm's clientele and associated account size simply do not create the financial incentives to engage in inappropriate business entertainment.<sup>10</sup> Nevertheless, those IBD firms who engage in minimal business entertainment will be forced to create systems from scratch to perform the recordkeeping and monitoring functions. In addition, training programs will need to be established to insure all personnel who supervise or administer the firm's procedures are properly educated. These efforts will involve substantial cost and the dedicated effort of their limited staff resources.<sup>11</sup> Customers of these firms, however, will realize almost no benefit. To the contrary, they will be asked instead to bear the cost inherent in the Proposal through increased charges for services to defray the firm's costs.

The NASD attempts to limit the impact of the Proposal on firms who engage in a minimal amount of business entertainment by establishing an exemption for members whose business entertainment expenses in the course of its fiscal year are below \$7,500. FSI applauds the NASD's effort to use a tiered approach to regulation in this context. Unfortunately, this threshold fails to achieve its stated goal by setting the figure too low. A simple example will demonstrate the point: a small IBD firm with 150 financial

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<sup>7</sup> NASD Notice to Members 06-06. See at [http://www.nasd.com/RulesRegulation/NoticestoMembers/2006NoticestoMembers/NASDW\\_015877](http://www.nasd.com/RulesRegulation/NoticestoMembers/2006NoticestoMembers/NASDW_015877).

<sup>8</sup> See "NASD Fines Jefferies & Company \$5.5 Million for Providing Improper Gifts and Excessive Entertainment to Fidelity Traders" (December 4, 2006) at [http://www.nasd.com/PressRoom/NewsReleases/2006NewsReleases/NASDW\\_018022](http://www.nasd.com/PressRoom/NewsReleases/2006NewsReleases/NASDW_018022).

<sup>9</sup> Letter from The Self-Regulation and Supervisory Practices Committee of the Securities Industry Association ("SIA"), dated Mar. 7, 2006. See at [http://www.nasd.com/RulesRegulation/NoticestoMembers/CommentsonNotice/NASDW\\_016158](http://www.nasd.com/RulesRegulation/NoticestoMembers/CommentsonNotice/NASDW_016158).

<sup>10</sup> FSI is aware that the NASD has indicated that it is not their intention for the amended IM-3060 to apply to retail customers of a member. However, the Proposal's definition of the term "customer" does not clearly exclude the small businesses, associations, organizations, and retirement plans that are a part of the typical independent financial advisor's universe of potential clients. Therefore, it does not fully reflect the intentions of the NASD and must be amended to do so.

<sup>11</sup> In addition, IBD firm recordkeeping associated with business entertainment will be complicated by the fact that financial advisors associated with IBD firms engage in a variety of outside activities in which business entertainment may also occur.

advisors would be subject to the Proposal's requirements if each advisor entertained a single customer representative a year with a \$50 dinner. Business entertaining of this nature could not be "reasonably judged to have the likely effect of causing, such customer representative to act in a manner that is inconsistent with...the best interests of the customer..."<sup>12</sup> Therefore, it should not be the behavior targeted by the Proposal.

To remedy this problem, FSI recommends that the Proposal be amended to define the term customer to only include institutional customers. The suggested amendment follows below:

(b) Definitions

For purposes of this interpretation, the following definitions shall apply:

(1) The term "customer" means:

(A) ~~a person~~ an institutional account that maintains a business relationship with a member via the maintenance of an account, through the conduct of investment banking, or pursuant to other securities-related activity; or

(B) ~~a person~~ an institutional account whose customer representative receives business entertainment for the purpose of encouraging such person to establish a business relationship with the member by opening an account with the member or by conducting investment banking or other securities-related activity with the member.

(C) "institutional account" as used herein shall have the same meaning as that in Rule 3110(c)(4).

This amendment would insure that the cost of compliance with the rule is borne by those firms who have the financial incentive to consider engaging in inappropriate activities like those that have given rise to past abuses.<sup>13</sup> Meanwhile, IBD firms and other small broker-dealers will not be burdened with the expense associated with monitoring business entertainment that is unlikely to improperly influence customer representatives.

2. Proposal is Overly Broad – The Proposal defines a customer representative as "a person who is an employee, officer, director, or agent of a customer..."<sup>14</sup> This definition is far too broad because it will encompass employees and agents of a customer who have no decision-making authority or control over decisions related to the customer's securities business. While it is clear that officers and directors are likely to possess the necessary authority to determine with whom their employer does business, employees and agents are less likely to do so. If the Proposal is intended to prohibit business entertainment that would be reasonably judged to have the likely effect of causing the customer representative to act in a manner that is inconsistent with the best interests of the customer, its impact should be limited to those persons who have the relevant authority

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<sup>12</sup> See SEC Release Nos.: 34-55765, File No.: SR-NASD-2006-044 (May 22, 2007).

<sup>13</sup> See "NASD Fines Jefferies & Company \$5.5 Million for Providing Improper Gifts and Excessive Entertainment to Fidelity Traders" (December 4, 2006) at [http://www.nasd.com/PressRoom/NewsReleases/2006NewsReleases/NASDW\\_018022](http://www.nasd.com/PressRoom/NewsReleases/2006NewsReleases/NASDW_018022). See also In the Matter of the Application of Rentz Company, Inc. 43 S.E.C. 436, Release No. 8134, Release No. 34-8134, 1967 WL 86368 (S.E.C. Release No.) (July 27, 1967), In the Matter of the Application of H. C. Keister Company H. C. Keister L. A. Sorenson (November 1, 1966) 43 S.E.C. 164, Release No. 7988, Release No. 34-7988, 1966 WL 84120 (S.E.C. Release No.). In the Matter of Pauline W. Rosenbloom doing business as The James Company and Robert I. Rosenbloom (December 7, 1965) 42 S.E.C. 860, Release No. 7762, Release No. 34-7762, 1965 WL 87591.

<sup>14</sup> See SEC Release Nos.: 34-55765, File No.: SR-NASD-2006-044 (May 22, 2007).

to impact such decisions. Since the Proposal is not limited in this regard, it is clearly overly broad.

FSI recommends that the definition of customer representative be amended as follows:

**(b) Definitions**

For purposes of this interpretation, the following definitions shall apply...

(2) The term "customer representative" means a person who ~~is~~ possesses decision-making authority relative to the customer's investment banking or other securities-related business, such as an employee, officer, director, or agent of a customer, unless such person is a family member of the customer.

3. Proposal is Unduly Burdensome - The Proposal imposes extensive recordkeeping obligations on member firms, including detailed records for any business expenses incurred in excess of \$50 per day to provide entertainment to any customer representative. In FSI's opinion it is unjustifiable to claim that \$50 of entertainment "would be reasonably judged to have the likely effect of causing, such customer representative to act in a manner that is inconsistent with...the best interests of the customer..."<sup>15</sup> The record keeping obligations created by such a low threshold are likely to be extensive, if not overwhelming. The costs associated with the design, implementation, and administration of this recordkeeping will be enormous. The dollar threshold is simply too low and, therefore, imposes unduly burdensome recordkeeping obligations on member firms.

To remedy this problem, FSI recommends that the Proposal be amended as follows:

**(d) Recordkeeping**

(1) Each member's written policies and procedures must require the maintenance of detailed records of business entertainment expenses provided to any customer representative. The member is not required to maintain records of:

- (A) business entertainment when the total value of the business entertainment, including all expenses associated with the business entertainment, does not exceed ~~\$50~~ \$100 per day; or
- (B) additional expenses incurred in connection with otherwise recorded business entertainment that do not, in the aggregate, exceed ~~\$50~~ \$100 per day...<sup>16</sup>

4. Proposal Unnecessarily Obligates All Firms to Adopt Procedures - Finally, FSI believes that the Proposal should provide clear guidance that member firms who do not engage in business entertainment are not required to adopt the procedures contemplated by IM-3060. The written supervisory procedures of a broker-dealer are far too important to burden with detailed discussions of procedures relating to activities in which the firm does not engage. As a result, we urge the SEC and NASD to exempt firms who do not engage in business entertainment from having to adopt the procedures delineated in this Proposal.

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<sup>15</sup> Ibid.

<sup>16</sup> This amendment would have the added benefit of making the Proposal consistent with the NASD's current rules on gifts and non-cash compensation.

In summary, FSI respects the NASD's concerns about the use of business entertainment to encourage employees to act in a manner inconsistent with their employer's best interests. However, FSI believes that the Proposal is overly broad, unduly burdensome, and unjustified in light of the substantial anticipated costs and limited benefits of the proposal. FSI strongly urges the SEC and NASD to amend their proposal as outlined above or to maintain the status quo by allowing the staff interpretation that has guided member's use of business entertainment since 1999 to remain in place.

Conclusion

We are committed to constructive engagement in the regulatory process and, therefore, would welcome the opportunity to work with you to find solutions to these concerns that achieve your objectives without the unintended consequences we have outlined above.

Again, thank you for the opportunity to comment on the Proposal. Should you have any questions, please contact me at 770 980-8487.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Dale E. Brown". The signature is stylized and cursive.

Dale E. Brown, CAE  
President & CEO