

# PACE INVESTOR RIGHTS PROJECT

Pace University School of Law

78 NORTH BROADWAY  
WHITE PLAINS, NY 10603  
WWW.LAW.PACE.EDU/PIRP

JILL I. GROSS, DIRECTOR  
PHONE: 914-422-4333  
FAX: 914-422-4391  
[JGROSS@LAW.PACE.EDU](mailto:JGROSS@LAW.PACE.EDU)

June 12, 2007

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

Re: File Number SR-NASD-2006-044: Relating to NASD Rule 3060  
Interpretive Material Addressing Gift and Entertainment Expenses

Dear Ms. Morris:

The Pace Investor Rights Project (PIRP) at Pace University School of Law appreciates the opportunity to comment on NASD's proposal to adopt interpretive material ("IM") to NASD Rule 3060, as outlined in the Notice of Filing, dated May 15, 2007.<sup>1</sup> PIRP's mission is to advocate on behalf of investor justice, particularly with respect to the rights of small investors.

PIRP writes with strong support and agreement with the objectives of the interpretive material that are geared to protect the fiduciary duties owed to the individual investor by their registered representatives.<sup>2</sup> We fully support requiring members or associates of members ("members") to adopt policies and procedures addressing business entertainment. However, we write specifically to object to the absence of guidance on standards to which these policies and procedures should be fashioned. We respectfully implore NASD to provide additional guidance concerning the IM as offered in its filing.<sup>3</sup>

As noted in the "*Purpose*" subsection of Part II Section A of the proposal, this IM is intended to replace the 1999 Rule 3060 interpretive letter. PIRP is concerned with the overriding nature of the new proposal. The 1999 letter required that business entertainment could be "neither so frequent nor so extensive as to raise any question of

---

<sup>1</sup> *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*, 72 Fed. Reg. 28743 (May 22, 2007).

<sup>2</sup> PIRP emphasizes its support of the standards delineated in the "General Requirements" section (a)(1) and (a)(2) of the proposed material.

<sup>3</sup> NASD promised commenters that it would "consider whether additional guidance concerning the IM is necessary." See *Notice of Filing, supra* note 1, at 28750.

propriety.” We believe that this language offered an important substantive standard that would be lost by implementing the new interpretive material.

Under the new interpretation, the standard derived from Rule 2110 is whether the business entertainment would cause its recipient customer to “act in a manner that is inconsistent with: (1) The best interest of the customer or (2) The best interest of any person to whom the customer owes a fiduciary duty.”<sup>4</sup> The newly proposed interpretation leaves the establishment of substantive standards to the sole discretion of the members. While these self-imposed standards would have to be established in conformity with Rule 2110,<sup>5</sup> the complete elimination of the earlier language opens the floodgates to a myriad of undesirable results. The problematic result of such a limited standard is that the nature of the business entertainment itself will no longer be the point of scrutiny but rather the effect the entertainment has on its recipient becomes the point of scrutiny. Such an undesirable result is illustrated in the following example:

Member firm “A” and member firm “B” both offer similar investment services. A and B are the only member firms that offer these services. Both firms sponsor an annual due diligence conference in which customer representative “X,” a New York based financial consultant, is invited to learn about the services. Both firms have their conference on similarly convenient dates. Both firms pay for X’s first class ticket to fly out to Las Vegas. Both firms pay for limousine services throughout the duration of the conference. Both firms pay for X’s hotel suite at the famous and expensive Bellagio hotel and casino for three evenings. Both firms conduct a number of educational meetings relaying important disclosures and suitability criteria regarding their services. Both firms provide three meals a day at the most exclusive restaurants in the city. And both firms pay for three daily golf outings.

In this example, since the accommodations provided by A and B were identical, X does not feel a higher degree of incentive to entrust his clients’ money to one firm over the other. Both firms have set up policies and procedures that carefully monitor any variations from this agenda that would give an incentive for a customer representative to entrust one firm over the other. Despite the extraordinary expenditures by firm A and B and the extravagant nature of the accommodations, the practices will not come under scrutiny under the proposed IM because both firm A and B have implemented the proper supervisory policies and procedures for monitoring the conference expenses. Since neither conference provokes the financial consultant to act in a manner inconsistent with his duties the practices of firm A and B will continue without being questioned.

---

<sup>4</sup> Proposed IM 3060 (a), General Requirements.

<sup>5</sup> The “*Define Forms of Appropriate and Inappropriate Business Entertainment*” section of the proposed IM suggests that members will have to adhere to the general spirit of “commercial honor” set forth in NASD Rule 2110 to make determinations of appropriateness. Notably, NASD hopes that members will implement standards in compliance with “commercial honor” under Rule 2110. However, this gives little additional guidance as paragraph (a) of the proposed IM is already a codification of Rule 2110.

However, under the language of the 1999 interpretation, firm A and B are required to consider the excessiveness of the entertainment expense. The implementation of a system lacking the type of guidance delineated in the 1999 interpretation will have detrimental consequences to individual investors, such as X's clients. For instance, X might convince his client to invest her money with member firm A. X has a feeling that this particular investment style is a bit too risky for the client but decides to sell her on the idea anyway. Consciously or not, he knows that if he continues to give firm A his clients' business, then he will continue to be invited to its annual conference. Although firm A could not have foreseen X's impropriety, the extravagant events enticed him to act in a manner inconsistent with the fiduciary responsibilities he owed to his client. In short, the tendency to aggregate funds to firms that host such lavish events may cause unsuitable recommendations to the individual investor.

Additionally, even if the investment is suitable, the extravagant costs of these events might be financed by the administrative and/or management fees paid by the investor to the member firm. If the luxurious frills are eliminated, leaving only those accommodations necessary to serve the objectives of the annual due diligence conference, investors will reap the benefits of the savings through higher returns on their investment. Over the course of many years, the compounded savings would be a substantial sum.

PIRP is concerned with the likelihood of the resulting detriment to the individual investor, particularly in an industry with long-standing traditions of accepted practices that are objectively excessive but when gauged relative to one another can seem unobjectionable. The danger of the proposed IM is that it explicitly removes the standards set in the 1999 letter and puts in its place a system of checks and balances that does not challenge the status quo.

## **Conclusion**

Members must be charged with the responsibility of maintaining and monitoring their practices in accordance with their ethical responsibility to the industry and their duties to the investing public. Correspondingly, we are pleased with the direction of the proposed IM to NASD Rule 3060. However, we request that the requirement to implement a supervisory system be accompanied with specific guidance on factors that are in harmony with the spirit of Rule 3060 and its parallel sections.

Respectfully Submitted,

*Jill Gross*  
Directory of Advocacy

*Jay Yamamoto*  
Student Intern