

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-55765; File No. SR-NASD-2006-044)

May 15, 2007

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing of Proposed Rule Change and Amendment Nos. 1 and 2 Thereto Relating to Interpretive Material to NASD Rule 3060 to Require Members to Adopt Policies and Procedures Addressing Business Entertainment

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on April 11, 2006, the National Association of Securities Dealers, Inc. (“NASD”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD. On April 17, 2007, NASD filed Amendment No. 1 to the proposed rule change.³ On May 1, 2007, NASD filed Partial Amendment No. 2 to the proposed rule change.⁴ The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.⁵

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

NASD is proposing to adopt Interpretive Material (“IM”) to NASD Rule 3060 to require members to adopt policies and procedures addressing business entertainment. Below is the text

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 1 replaced and superseded the original rule filing in its entirety.

⁴ Partial Amendment No. 2 attached Exhibit 4 of Amendment No. 1, which shows changes of the proposed rule text from the immediately preceding filing.

⁵ The Commission also is separately publishing a notice by the New York Stock Exchange LLC (“NYSE”) to propose new NYSE Rule 350A on business entertainment, which is substantially similar to NASD’s proposed rule text. See Securities Exchange Act Release No. 55766 (May 15, 2007) (SR-NYSE-2006-06). The NYSE proposal and the NASD proposal primarily differ in that the NYSE proposal contains a “Notice to Customers” provision. See discussion infra Part IV, Solicitation of Comments section.

of the proposed rule change. Proposed new language is in italics.

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IM-3060. Business Entertainment

The NASD Board of Governors is issuing this interpretation concerning the obligations of a member in connection with any business entertainment of a customer representative. This interpretation does not apply to any non-cash compensation that falls within Rule 2820(g) or Rule 2830(l) (i.e., entertainment provided by offerors to associated persons of a member in connection with the sale and distribution of variable contracts or investment company securities). This interpretation does not apply to any member that does not engage in business entertainment. For any member that engages in business entertainment, this interpretation applies only with respect to business entertainment provided to customer representatives. This interpretation supersedes any prior interpretive letters or statements of NASD staff regarding business entertainment under Rule 3060.

(a) General Requirements

No member or person associated with a member shall, directly or indirectly, provide any business entertainment to a customer representative pursuant to the establishment of, or during the course of, a business relationship with any customer that is intended or designed to cause, or would be reasonably judged to have the likely effect of causing, such customer representative to act in a manner that is inconsistent with:

- (1) the best interests of the customer; or
- (2) the best interests of any person to whom the customer owes a fiduciary duty.

(b) Definitions

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

(1) The term “customer” means:

(A) a person 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 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.

(2) The term “customer representative” means a person who is an employee, officer, director, or agent of a customer, unless such person is a family member of the customer.

(3) The term “family member” means a person’s parents, mother-in-law or father-in-law, spouse, brother or sister, brother-in-law or sister-in-law, son-in-law or daughter-in-law, and children.

(4) The term “business entertainment” means 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 an associated person of a member accompanies a customer representative.

(A) If a customer representative is not accompanied by an appropriate associated person of the member, any expenses associated with the business

entertainment will be considered a gift under Rule 3060 unless exigent circumstances make it impractical for an associated person of the member to attend. All instances where such exigent circumstances are invoked must be clearly and thoroughly documented and be subject to the prior written approval of a designated supervisory person or, in very limited circumstances where such prior approval cannot reasonably be obtained, to a prompt post-event review to be conducted and documented by such supervisory person.

(B) Anything of value given or provided to a customer representative that does not fall within the definition of “business entertainment” is a gift under Rule 3060.

(C) In valuing business entertainment expenses pursuant to this interpretation, a member’s written policies and procedures must specify the methodology to be used by the member to calculate the value of business entertainment. In general, business entertainment expenses should be valued at the higher of face value or cost to the member.

(c) Written Policies and Procedures

(1) Each member must have written policies and supervisory procedures that:

(A) define 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 type and class of any accommodations or transportation provided in connection with such business entertainment; and

(B) make clear that anything of value given or otherwise provided to a

customer representative that does not fall within the definition of “business entertainment” is a gift under Rule 3060; and

(C) impose either specific dollar limits on business entertainment or require advance written supervisory approval beyond specified dollar thresholds; and

(D) are 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 or undermine the performance of a customer representative’s duty to a customer or any person to whom the customer owes a fiduciary duty; and

(E) establish standards to ensure that persons designated to supervise and administer the written policies and procedures are sufficiently qualified; and

(F) require appropriate training and education for all personnel who supervise, administer, or are subject to the written policies and procedures.

(2) A member’s written policies and procedures may distinguish, and set specifically tailored standards for, business entertainment in connection with events that are deemed to be primarily educational, charitable, or philanthropic in nature, provided that such standards comply with the requirements of this interpretation and are explicitly addressed in the written policies and procedures.

(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 per day; or

(B) additional expenses incurred in connection with otherwise recorded business entertainment that do not, in the aggregate, exceed \$50 per day.

(2) Each member's written policies and procedures must include provisions reasonably designed to prevent associated persons of the member from circumventing the recordkeeping requirements in contravention of the spirit and purpose of this interpretation (e.g., a pattern of providing a customer representative with business entertainment valued at \$48).

(3) Each member's written policies and procedures must require that, upon a customer's written request, the member will promptly make available to the customer any business entertainment records regarding business entertainment provided to customer representatives of that customer.

(e) Exemption for Members with Business Entertainment Expenses Below \$7,500

A member whose business entertainment expenses in the course of its fiscal year are below \$7,500 shall be subject only to paragraphs (a), (b), and (c)(1)(D) and (E) of this interpretation, and shall be exempt from paragraphs (c) (other than (c)(1)(D) and (E) as noted above) and (d). Each member that relies on this exemption must evidence that its business entertainment expenses are below the \$7,500 threshold.

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II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, NASD included statements concerning the purpose of

and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

(A) Background

NASD Rule 3060 prohibits any member or person associated with a member, directly or indirectly, from giving 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. In 1999, NASD staff issued an interpretive letter stating that Rule 3060 does not prohibit “ordinary and usual business entertainment” (such as an occasional meal, sporting event, theater production, or comparable entertainment event) provided that the entertainment “is neither so frequent nor so extensive as to raise any question of propriety.”⁶ The 1999 Letter noted that the interpretation was based, in part, on NASD’s rules governing non-cash compensation in connection with the offer and sale of investment company shares and variable annuities.

Recently, NASD members have requested more guidance on the rules concerning gifts and business entertainment in the wake of press reports of enforcement actions regarding gifts and gratuities.⁷ In response to these requests, NASD is proposing interpretive material to NASD

⁶ Letter to Henry H. Hopkins and Sarah McCafferty, T. Rowe Price Investment Services, Inc., from R. Clark Hooper, NASD, dated June 10, 1999 (“1999 Letter”), available at http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_002715.

⁷ See, e.g., Jenny Anderson, Fidelity Disciplines 16 Traders Over Gifts From Brokers, N.Y. Times, Dec. 17, 2004, at C5; Andrew Caffrey & Jeffrey Krasner, Probe of Gifts

Rule 3060 to outline the policies and procedures that a member must adopt in connection with its business entertainment practices.⁸ The proposed rule change would supersede any prior guidance of NASD staff regarding business entertainment under Rule 3060, including the 1999 Letter. The proposed rule change would not supersede any guidance provided under other NASD rules.⁹ NASD has also clarified that any non-cash compensation falling under Rule 2820(g) or Rule 2830(l) would be subject to the standards imposed by those rules.¹⁰

Rule 3060 is intended to prevent improprieties that may arise when a member or an associated person of a member gives gifts or gratuities to employees of a customer. To guard against these improprieties, Rule 3060 imposes a \$100 annual limit on gifts and gratuities that a member or person associated with a member can give to an employee of a customer in relation to the employer firm's business. However, ordinary and usual business entertainment is not considered a gift or gratuity and is permitted "so long as it is neither so frequent nor so extensive as to raise any question of propriety."¹¹ The proposed rule change is intended to replace this statement regarding business entertainment with an approach that permits each member to adopt

Said to Focus on Fidelity, Boston Globe, Dec. 7, 2004, at A1; Probe on Gifts to Fund Officials Is Said to Include Jefferies, Los Angeles Times, Dec. 3, 2004, at C4; Jenny Anderson, On Wall Street, A Closer Look At Giving Gifts, N.Y. Times, Nov. 24, 2004, at C1; Greg Farrell, Brokerages' gifts to mutual fund managers scrutinized, USA Today, Nov. 24, 2004, at B2.

⁸ In addition, NASD also recently published guidance concerning gifts and gratuities under Rule 3060. See Notice to Members 06-69 (December 2006).

⁹ For example, the proposed rule change would not supersede the guidance given by NASD staff in Notice to Members 99-55 (July 1999) concerning NASD Rules 2820 and 2830.

¹⁰ NASD published a Notice to Members requesting comment on a proposed rule change to replace Rules 2820(g) and 2830(l), among others, with a new Rule 2311. See Notice to Members 05-40 (June 2005). If such a rule change is proposed and approved, NASD will amend the language of proposed IM-3060 to reflect the change.

¹¹ See 1999 Letter.

specific policies and procedures tailored to its business needs. The proposed rule change also seeks to provide members with general guidance concerning the types of issues that a firm's policies and procedures must address and mandates that each member maintain appropriate records to ensure that persons associated with the member are complying with the written policies and procedures.

In general, NASD, working closely with the New York Stock Exchange (the "NYSE"), concluded that, in clarifying a member's obligation under Rule 3060, a specific standard was unworkable and impractical.¹² As NASD noted in the Notice to Members seeking comment on the proposed rule change, "the proposed IM does not impose hard limits, nor does it require that all members adopt the same limits or even treat all recipients equally."¹³ Rather, the proposed rule change requires that each member assess its use of business entertainment, determine what limitations are appropriate and meet the general guidelines set forth in the proposed rule change, and adopt written policies and procedures to ensure that persons associated with the member are following those limitations. The introductory paragraph in the proposed interpretation also makes clear that the interpretation does not apply to any member that does not engage in business entertainment.

While, as discussed below, some commenters criticized a general, principles-based approach as lacking clarity and uniform standards, NASD and the NYSE both concluded that such an approach was more appropriate. The proposed rule change expands upon the existing principles-based approach to business entertainment established in the 1999 Letter but specifically addresses the content of a member's written policies and procedures.

¹² The NYSE also has filed a proposed rule change with the Commission addressing business entertainment. See supra note 5.

¹³ See Notice to Members 06-06 (January 2006).

(B) General Requirements

The observance of “high standards of commercial honor and just and equitable principles of trade” required of a member in the conduct of its business under NASD Rule 2110 includes the obligation of a member not to act in a manner contrary to the best interests of a customer in the conduct of business with or for such customer. Consequently, when a member interacts with an employee—or any other agent—of a customer, the member should not give that person anything of value that is intended or designed to cause, or otherwise would be reasonably judged to have the likely effect of causing, such person to act in a manner that is inconsistent with the best interests of the customer or any person to whom the customer owes a fiduciary duty.¹⁴ Paragraph (a) of the proposed rule change codifies this concept by explicitly setting forth the general purpose behind proposed IM-3060.

NASD believes that the guiding principle in navigating the concern of placing a customer representative in conflict with his duty to a customer is that members should compete for business on the basis of providing the best professional services. While it is not inappropriate for business entertainment to foster an environment for the member to promote or educate the customer representative with respect to such professional services, it is inconsistent with the terms of proposed IM-3060 to use business entertainment to provide incentives to customer representatives to conduct customer business with and/or through the member without due consideration as to whether the nature and terms of such professional services meet the objectives and are in the best interests of the account.

¹⁴ NASD Rule 2110 precludes the offering of any thing of value, including but not limited to business entertainment, that comprises conduct that, to any degree, is either illegal under any applicable law or would expose the member, customer, or recipient of the member’s business entertainment to any civil liability. For example, any business entertainment that violated the Foreign Corrupt Practices Act or any commercial bribery statutes and laws would, in turn, violate Rule 2110.

(C) Definitions

There are three defined terms that are integral to an understanding of the proposed rule change.¹⁵ First, “customer” is defined as (1) “a person 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 (2) “a person 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.”¹⁶ The definition of “customer” has been amended from the previous rule filing; however, the changes do not affect those persons considered “customers” for the purpose of the proposed rule change.

Second, for purposes of the proposed rule change, a “customer representative” means “a person who is an employee, officer, director, or agent of a customer, unless such person is a family member of the customer.” The term “customer representative” replaces the term “employee” in the previous rule filing to clarify that the term includes persons other than employees. The term also now conforms to the terminology in the NYSE’s proposed rule change. Moreover, the definition has been amended to exclude certain family members from the definition of customer representative.¹⁷ This exclusion has been added to the definition to address situations where a close family member has power-of-attorney or similar authority over another family member’s account (e.g., an adult child with authority over his or her elderly

¹⁵ Terms used in the interpretation have the same meaning as those defined in NASD’s By-Laws and rules unless otherwise specified.

¹⁶ NASD Rule 0120(n) defines the term “person” to “include any natural person, partnership, corporation, association, or other legal entity.”

¹⁷ The term “family member” means a person’s parents, mother-in-law or father-in-law, spouse, brother or sister, brother-in-law or sister-in-law, son-in-law or daughter-in-law, and children.

parent's account). NASD believes that these situations are unlikely to result in the types of conflicts of interest the proposed rule change seeks to address.

This definition, when coupled with the general requirements set forth in paragraph (a) of the proposed rule change, limit the proposed rule change to business entertainment provided to a customer representative. This point is explicitly addressed in the preamble to the interpretation, which states: "This interpretation does not apply to any member that does not engage in business entertainment. For any member that engages in business entertainment, this interpretation applies only with respect to business entertainment provided to customer representatives." Thus, the proposed rule change does not address business entertainment provided to a natural person customer.¹⁸ It addresses only business entertainment provided to a customer representative of the customer (although such customer may be a natural or non-natural person).

Third, "business entertainment" is defined as "any social event, hospitality event, sporting event, entertainment event, meal, leisure activity, or event of like nature or purpose, including 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 an associated person of a member accompanies a customer representative." This definition codifies NASD's long-standing position that an associated person of a member must accompany or participate in an event for it to be deemed "business entertainment" rather than a "gift." In addition, NASD has deleted the portion of the definition that stated that it is not

¹⁸ As discussed in footnote 5 of Notice to Members 06-06, and as noted below, natural persons who are both natural person customers and customer representatives should be treated as customer representatives. That is, associated persons of a member cannot avoid the application of the firm's business entertainment policies by claiming that business entertainment provided to a person who is both a natural person customer and a customer representative was provided to that individual solely in his or her "personal," rather than business, capacity.

necessary for business to be conducted for an event to be “business entertainment.” The definition of business entertainment encompasses all the events enumerated provided that the customer representative is accompanied by an associated person of the member; because the clause did not further define business entertainment, it has been deleted.

As noted above, the definition of “business entertainment” generally prescribes that if a customer representative is not accompanied by an appropriate associated person of a member, any expenses associated with the business entertainment will be considered a gift under Rule 3060. An exception to this requirement is proposed to address instances when exigent circumstances make it impractical for an associated person of a member to attend a business entertainment event. All instances where such exigent circumstances are invoked must be clearly and thoroughly documented and be subject to the prior written approval of a designated supervisory person or, in very limited circumstances where such prior approval cannot reasonably be obtained, to a prompt post-event review to be conducted and documented by such supervisory person.

NASD believes that the “exigent circumstances” exception provides necessary flexibility in light of real-world, last minute emergency situations that could arise that would make it difficult, if not impossible, for an appropriate associated person of a member to attend a business entertainment event with a customer representative. Examples of exigent circumstances would be a sick child, an accident, or some other sudden, overriding circumstance. NASD does not believe this provision would lead to circumvention of the spirit or substance of the proposed rule change since all such occurrences are subject to detailed documentation such that any patterns of abuse would become quickly apparent to supervisory personnel.

Paragraph (b)(4)(C) of the proposed rule change provides guidance to members on the

valuation of business entertainment. The proposed rule change requires that a member's written policies and procedures specify how the firm will calculate the value of business entertainment. In general, business entertainment items should be valued at the greater of face value or cost to the member.

NASD has been asked about the extent to which the proposed rule change reaches business entertainment conducted outside the United States, particularly entertainment provided by persons who are employed in commonly controlled affiliates of a financial services company operating in the United States and/or foreign jurisdictions. As an initial matter, proposed IM-3060 reaches all business entertainment of a member firm and persons associated with a member, even if such entertainment occurs outside of the United States or is provided to foreign individuals. However, NASD does not believe that all persons who are employed in commonly controlled affiliates of a financial services company operating in the United States and/or foreign jurisdictions are necessarily associated persons of the member, even if they report to a person who, in another capacity, is an associated person of a member.

An associated person of a member may have management and supervisory responsibilities for non-member affiliates of a financial services company, located within or outside of the United States, without the result that the persons being managed and supervised in the non-member affiliates would necessarily be deemed associated persons of the member. It is the view of NASD that in such instances the following factors establish that an employee of a non-member affiliate is not an associated person of the member: (1) the manager/supervisor of that employee is recognized in the organization as having a scope of responsibilities outside of the member firm; (2) the exercise of the management and supervision over that employee by such manager/supervisor is not controlled by the member, is reviewable for purposes of

performance and compensation outside of the member, and is not conducted for the benefit of the member; and (3) the employee of the non-member affiliates is not otherwise employed or engaged in the investment banking or securities business of the member and controlled by the member in respect of such activities.

(D) Written Policies and Procedures

A member's policies and procedures must be designed to promote conduct consistent with NASD Rule 2110 and should not undermine the performance of a customer representative's duty to a customer. The proposed rule change requires members to adopt written policies and procedures concerning business entertainment that: (1) define 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 type and class of any accommodation or transportation provided in connection with such business entertainment; (2) impose either specific dollar limits on business entertainment or require advance written supervisory approval beyond specified dollar thresholds; (3) are 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 or undermine the performance of a customer representative's duty to a customer; (4) establish standards to ensure that persons designated to supervise and administer the written policies and procedures are sufficiently qualified; and (5) require appropriate training and education for all personnel who supervise, administer, or are subject to the written policies and procedures.

(i) Define Forms of Appropriate and Inappropriate Business Entertainment

A member's written policies and procedures concerning business entertainment must define 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 type and class of any accommodations or transportation provided in connection with such business entertainment. A member's policies and procedures should include provisions regarding appropriate venues, nature, frequency, and types and class of accommodation and transportation.

A member may determine that certain activities, though legal, are nevertheless inappropriate for business entertainment. NASD believes that the standards of business entertainment adopted by members must meet the requirements of Rule 2110 that members and persons associated with a member adhere to high standards of commercial honor. Consequently, a member would violate proposed IM-3060 not only if it failed to adopt procedures, but also if the procedures set standards that are so unbounded or vague that no reasonable determination of propriety can be discerned.

The proposed rule change also would allow, but not require, members to establish different standards for business entertainment in connection with events that are educational, charitable, or philanthropic in nature. If a member chooses to distinguish between forms of business entertainment in its policies and procedures, it should ensure that these types of business entertainment nonetheless comply with Rule 2110 and the general requirements set forth in paragraph (a) of the proposed rule change.

- (ii) Impose Either Specific Dollar Limits on Business Entertainment or Require Advance Written Supervisory Approval Beyond Specified Dollar Thresholds

A member's written policies and procedures must impose either specific dollar limits on business entertainment or require advance written supervisory approval beyond specified dollar thresholds. The proposed rule change does not impose hard dollar limits or require that all

members adopt the same dollar limits or treat all recipients equally.

(iii) 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

A member's written policies and procedures must 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. For example, members should develop written policies and procedures reasonably designed to preclude providing business entertainment that is so lavish or extensive in nature that a customer representative would likely feel compelled to place order flow on behalf of the customer without due regard to best execution or other transaction pricing considerations. NASD does not intend that this standard would establish a per se violation of the proposed IM if a customer representative who received business entertainment from the member is later found to have violated his or her obligations to his or her employer; however, such actions by a customer representative may warrant further investigation by the member firm as to whether the member's policies and procedures are, in fact, reasonably tailored to prevent these types of violations.¹⁹ While an NASD member is not ultimately responsible for the conduct of its customers' employees or agents, the member is responsible for ensuring that persons associated with the member do not engage in activities that are designed to, or reasonably likely to, cause the recipient to engage in improper conduct. Moreover, a member's compliance with its policies and procedures would not serve to automatically shield the member from all liability under the proposed IM for any misconduct by a customer representative.

(iv) Supervision

¹⁹ NASD Rule 3012(a) requires members to test and verify their supervisory procedures and "create additional or amend supervisory procedures where the need is identified by such testing and verification."

As is the case with every NASD rule, supervision is a critical component of business entertainment policies and procedures. Members are free to define the approach and method of their written policies and procedures provided they are reasonably designed to comport with the principles stated in the proposed rule filing. Irrespective of the manner in which a member crafts its procedures, it must be clear from the supervisory policies and procedures what factors determine appropriate levels of business entertainment and how those determinations are executed, monitored, and enforced. This is particularly true if members elect to use qualitative, rather than quantitative, standards. In addition, such supervisory procedures should provide a method for evidencing both the breadth of supervisory activities as well as the information upon which such supervision is conducted. For example, a member's policies and procedures must evidence the basis upon which a supervisor will determine that business entertainment does not violate a member's standards as to the nature, frequency, and dollar amounts of entertainment.

A member's policies and procedures must establish standards to ensure that persons designated to supervise and administer the member's written policies and procedures are sufficiently qualified. The requirement that the persons designated to supervise business entertainment expenses be "sufficiently qualified" is not intended to impose a registration requirement or similar obligation on these individuals; rather, the requirement is intended to ensure that the member's designation is of persons who are familiar with the applicable regulatory requirements and are sufficiently senior and experienced to entrust with the approval obligations envisioned by the member's policies and procedures.

(v) Training and Education

A member's business entertainment policies and procedures must require appropriate training and education to all applicable personnel. A member also must be able to demonstrate

that it trains persons associated with the member who supervise, administer, and are subject to such written business entertainment policies and procedures in all applicable requirements.

(E) Recordkeeping

The only effective way for a member to ensure that persons associated with the member are following the firm's policies and procedures is to establish a system to track their business entertainment expenses. Consequently, a member's policies and procedures are required to include procedures regarding the maintenance of detailed records of business entertainment expenses provided to any customer representative.

NASD recognizes that recordkeeping requirements present compliance burdens for firms, and NASD has sought to address the potential burden by providing a recordkeeping carve-out for small expenditures, none of which would reasonably be expected to influence the behavior of the recipient. Consequently, the proposed rule change provides that members are not required to maintain records of (1) business entertainment when the total value of the business entertainment, including all expenses associated with the business entertainment, does not exceed \$50 per day or (2) additional expenses incurred in connection with otherwise recorded business entertainment that do not, in the aggregate, exceed \$50 per day.²⁰

The \$50 threshold would apply only to events or activities with a total cost that did not exceed \$50 per day (e.g., an inexpensive lunch) or to minor expenses related to an otherwise reported business entertainment event (such as a hot dog at an NBA basketball game, where the basketball game ticket is reported as a business entertainment expense). Firms may not allow

²⁰ Members should be aware, however, that they may need to track such expenses under other NASD or SEC rules. There is no express exclusion from Rule 3060 for gifts given during the course of business entertainment. See Notice to Members 06-69 (December 2006). NASD staff has, however, provided guidance that Rule 3060 does not apply to certain promotional items of nominal value that display the firm's logo. See id.

persons associated with the member to disaggregate business entertainment expenses relating to an activity or event in an effort to avoid recordkeeping obligations. Thus, a dinner expense of \$40 followed by a sporting event with a ticket price of \$40 would need to be tracked under the member's recordkeeping system.

The proposed rule change also requires that a member's written policies and procedures include provisions reasonably designed to prevent persons associated with the member from circumventing the recordkeeping requirements in contravention of the spirit and purpose of proposed IM-3060. Thus, for example, members should seek to prevent associated persons of the member from engaging in patterns of providing business entertainment that falls below the \$50 reporting threshold.

One of the key elements of the proposed rule change is the ability of a customer to request from the member information regarding the business entertainment expenses provided to the customer representatives of the customer. Although members are permitted to establish reasonable guidelines regarding a customer's ability to request this information, such guidelines must not impair the ability of the customer to obtain, on a reasonable and regular basis, information concerning the member's business entertainment expenses pertaining to the customer representatives of such customer.

(F) Exemption for Members with Business Entertainment Expenses Below \$7,500

The concerns that the proposed interpretation seeks to address are not presented by those members that, in the aggregate, do not devote significant resources to business entertainment. Consequently, the interpretation provides for a partial exemption for those members with annual business entertainment expenses below \$7,500. The provision provides that the \$7,500 ceiling should be measured on a fiscal year basis. Each member that relies on the exemption must

evidence that its business entertainment expenses were below the threshold.

Importantly, the exemption is not a total exemption from all aspects of the proposed interpretation. All members (except those members that do not engage in any business entertainment) are required to abide by the interpretation's general requirements as set forth in paragraph (a) and are required to have written policies and supervisory procedures that are 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 or undermine the performance of a customer representative's duty to a customer or any person to whom the customer owes a fiduciary duty, and establish standards to ensure that persons designated to supervise and administer such policies and procedures are sufficiently qualified.

The effective date of the proposed rule change will be six months following Commission approval. NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval.

2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,²¹ which requires, among other things, that NASD rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that the proposed rule change clarifies existing obligations of members with respect to the provision of business entertainment and will help prevent conduct by associated persons of a member that could undermine the performance of an employee's duty to the member's customer.

²¹ 15 U.S.C. 78o-3(b)(6).

B. Self-Regulatory Organization’s Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization’s Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The proposed rule change was published for comment in NASD Notice to Members 06-06 (January 2006). NASD received 28 comments in response to the Notice.²² A copy of the Notice to Members was attached to the original rule filing as Exhibit 2a. Copies of the comment letters received in response to the Notice were attached to the original rule filing as Exhibit 2b. Of the 28 comment letters received, 12 were generally in favor of the proposed rule change, 13

²² Letter from Pinnacle Taxx Advisors, Inc. (“Pinnacle”), dated Jan. 26, 2006; Letter from Keefe, Bruyette & Woods (“KBW”), dated Jan. 26, 2006; Letter from J.P. Morgan, dated Jan. 30, 2006; Letter from Evolve Securities, Inc. (“Evolve”), dated Jan. 31, 2006; Letter from Seasongood & Mayer, LLC (“Seasongood”), dated Feb. 2, 2006; Letter from Plexus Consulting (“Plexus”) o/b/o International Association of Small Broker Dealers and Advisers, dated Feb. 6, 2006; Letter from Dominion Investor Services, Inc. (“Dominion”), dated Feb. 13, 2006; Letter from National Regulatory Services (“NRS”), dated Feb. 6, 2006; Letter from T. Rowe Price Investment Services, Inc. (“T. Rowe Price”), dated Feb. 17, 2006. Letter from Maplewood Investment Advisors, Inc. (“Maplewood”), dated Feb. 22, 2006; Letter from Financial Services Institute, Inc. (“FSI”), dated Feb. 23, 2006; Letter from Transamerica Financial Advisors, Inc. (“Transamerica”), dated Feb. 23, 2006; Letter from H.D. Vest Financial Services (“H.D. Vest”), dated Feb. 23, 2006; Letter from ING US Financial Services (“ING”), dated Feb. 23, 2006; Letter from The Investment Company Institute (“ICI”), dated Feb. 23, 2006; Letter from Hines Real Estate Securities, Inc. (“Hines”), dated Feb. 21, 2006; Letter from The National Society of Compliance Professionals (“NSCP”), dated Feb. 23, 2006; Letter from Financial Network, dated Feb. 23, 2006; Letter from Coker Palmer, dated Feb. 23, 2006; Letter from Griffin, Kubik, Stephens & Thompson, Inc. (“Griffin”), dated Mar. 2, 2006; Letter from Debevoise & Plimpton LLP (“Debevoise”) o/b/o The Midtown Regulatory Group, dated Mar. 3, 2006; Letter from Transamerica Capital, Inc. (“Transamerica Capital”), dated Mar. 3, 2006; Letter from The Bond Market Association (“BMA”), dated Mar. 3, 2006; Letter from Goodwin Browning & Luna Securities, Inc. (“GB&L”), dated Mar. 3, 2006; Letter from The ABA Securities Association (“ABASA”), dated Mar. 3, 2006; Letter from Wachovia Capital Markets, LLC (“Wachovia”), dated Mar. 3, 2006; Letter from Neal E. Nakagiri (“Nakagiri”), dated Mar. 3, 2006; and Letter from The Self-Regulation and Supervisory Practices Committee of the Securities Industry Association (“SIA”), dated Mar. 7, 2006.

were opposed, and three took no clear position.

A number of commenters raised concerns with NASD's general, principles-based approach to the proposed rule change²³ and questioned the overall need for the IM.²⁴ As indicated above, the proposed rule change was undertaken in response to requests by NASD members for clarity concerning appropriate business entertainment. Both NASD and the NYSE undertook to provide members with additional guidance following these requests. To the extent some commenters questioned whether NASD should seek to "regulate" the employees of their members' customers, these commenters fail to recognize that NASD staff guidance in the 1999 Letter already prohibits business entertainment for employees of customers that is so frequent or excessive as to raise questions of propriety. Moreover, as discussed above, NASD is not seeking to regulate the behavior of the representatives of a member's customers;²⁵ rather, NASD is requiring each member to develop and enforce some appropriate degree of limitation on the business entertainment that persons associated with the member provide to its customers' representatives. In achieving this end, both NASD and the NYSE believe that a general,

²³ See, e.g., Letters from Dominion, Financial Network, H.D. Vest, Hines, Plexus, and NRS.

²⁴ See, e.g., Letters from Evolve, Financial Network, FSI, GB&L, H.D. Vest, ING, Maplewood, Nakagiri, and Transamerica Capital. Several commenters indicated that the proposed rule change should be made through notice and comment rulemaking with the Commission. As the Notice to Members stated, Section 19 of the Securities Exchange Act of 1934 requires that proposed rule changes such as IM-3060 be approved by the Commission following publication for public comment in the Federal Register. See Notice to Members 06-06, at 2 & n.2.

²⁵ NASD recognizes that customers whose representatives receive business entertainment have the responsibility to ensure that their representatives do not engage in improper conduct. However, NASD believes that the person providing business entertainment cannot disclaim any responsibility for improper conduct that flows directly from business entertainment its employee provided when the employee either intended for the business entertainment to have that effect or could reasonably have judged that the business entertainment would be likely to have that effect.

principles-based approach is more appropriate than a restrictive, one-size-fits-all regulatory scheme. Given the significant variation in broker-dealer business models and size, and regional differences in what may be considered appropriate business entertainment, NASD concluded that a fixed-dollar standard or similar specific mandate would prove unworkable.

One commenter suggested that NASD exempt certain small broker-dealers, at least in part because they lack the resources to affect decision-making in the manner the IM seeks to prohibit and that such extravagant and extensive business entertainment is localized among larger firms and does not occur in rural or small-market areas.²⁶ In response to this comment, NASD has included a limited exemption for members whose total business entertainment expenses in the course of their fiscal year are below \$7,500. The exemption provides relief from the recordkeeping requirements of the rule, as well as many of the specific requirements regarding written policies and supervisory procedures. NASD believes, however, that the general requirements of the proposed rule change should apply to all members that engage in business entertainment. In addition, members that engage in business entertainment should have written policies and supervisory procedures that are designed to detect and prevent improper conduct. As noted above, the proposed rule change does not apply to any member firm that does not engage in any form of business entertainment.

Several commenters suggested that NASD identify in the IM the specific factors to be considered by firms in developing their written policies and procedures, such as those identified by the NYSE in its rule filing. 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

²⁶ Letter from Evolve.

designed to achieve.²⁷ NASD staff will consider whether additional guidance concerning the IM is necessary when announcing the proposed rule change in a Notice to Members.

Several commenters expressed concern that the proposed rule change, including some of the defined terms, was too vague and may, in application, prove overly broad. Among other things, these commenters suggested that the proposed rule change could disadvantage firms with more conservative policies and procedures,²⁸ effectively require pre-approval of all business entertainment,²⁹ and introduce disadvantages among different types of firms and other industry participants.³⁰ Other commenters believed that the principles-based approach proposed by NASD is the appropriate manner to address the needed clarification of business entertainment.³¹

While NASD recognizes that there will be distinctions among each member's written policies and procedures, NASD concluded that member firms were in the best position to determine appropriate limitations and restrictions on the business entertainment provided by persons associated with a member. After considering the various comments concerning the definitions of "customer" and "business entertainment" in the proposed rule change,³² NASD has determined not to amend the definitions substantively.³³ While several commenters recommended that the definition of customer track the definition of "accredited investor" as defined in SEC Rule 501 under the Securities Act of 1933, NASD staff does not believe that the

²⁷ See Letter from BMA.

²⁸ See, e.g., Letters from Hines and ING.

²⁹ See Letter from Transamerica Capital.

³⁰ See, e.g., Letters from Dominion and Seasongood.

³¹ See Letters from BMA, Griffin, NSCP, and Wachovia.

³² See, e.g., Letters from BMA, Financial Network, FSI, ING, and Transamerica Capital.

³³ As noted in footnote 2 above, although the language in the definitions has been modified, the substance and breadth has been retained.

application of the IM should be dependent on any particular level of assets. While member firms may choose to treat certain types of customers or certain types of business entertainment differently for purposes of their written policies and procedures, NASD believes that, for purposes of the proposed rule change, a broad definition of each is appropriate.

With respect to one comment, NASD believes that it would be appropriate for a member's written policies and procedures to allow case-by-case review and approval for types of entertainment not specifically set forth in the member's policies and procedures.³⁴ One commenter was concerned that a registered representative may not be aware whether a recipient of business entertainment is a representative of a customer of the firm.³⁵ If a person is entertained in his personal capacity as a natural person client, and the firm has information barriers that would prevent the person providing the business entertainment from knowing that the person represents another customer as a representative, and the person providing business entertainment has no knowledge that such person is a representative of a customer at the time of the business entertainment, then such entertainment would fall outside the scope of the IM.

Several commenters raised suggestions concerning Rule 3060's limitation on gifts and gratuities, ranging from comments focused on increasing the \$100 limitation, moving from a hard figure standard to a principles-based approach, and providing guidance on the types of gifts and incidental expenses that should be included or excluded from any limitation.³⁶ The proposed rule change is focused on business entertainment, which is excepted from the limitation on

³⁴ See Letter from Debevoise.

³⁵ See Letter from FSI.

³⁶ See, e.g., Letters from ABASA, BMA, Debevoise, Evolve, Financial Network, and Wachovia.

“gifts,” and NASD is not currently considering amending the rule regarding gifts and gratuities.³⁷ NASD has long recognized that gifts—in contrast to business entertainment—are not incidental to the transaction of business. NASD requires that any gifts be de minimis and sees no reason to depart from this long-held view. NASD does not believe that the proposed rule change is the appropriate forum for providing interpretive advice on other aspects of Rule 3060; however, NASD staff recently published additional guidance on Rule 3060 regarding gifts and gratuities. See Notice to Members 06-69 (December 2006).

Two commenters expressed concern that the IM shifts the burden of proof required under NASD Rules and suggested that any change to Rule 3060 be done through a separate rule proposal rather than through an IM.³⁸ As discussed in footnote 2 and the accompanying text of Notice to Members 06-06, the IM, which is the equivalent of a rule provision, is being proposed in accordance with the procedures for a proposed rule change under Section 19 of the Act.³⁹ Rule 3060 and IM-3060 are two separate provisions, and the burden of proof under Rule 3060 is not affected by the proposed IM.

Several commenters appeared concerned that the discussion in footnote 5 of Notice to Members 06-06 would prohibit entertaining friends and relatives. This misconstrues the meaning of footnote 5, which says: “Members cannot circumvent this proposed interpretive material by providing business entertainment to a natural person customer who also is an employee, agent or representative of a customer by claiming that such business entertainment

³⁷ The one exception is the one noted above with respect to exigent circumstances. Numerous commenters requested that NASD adopt the exigent circumstances exception from the gift rule similar to the exception that the NYSE has proposed. See, e.g., Letters from ABASA, BMA, and Wachovia. As discussed above, NASD has determined that it is appropriate to provide for such an exception.

³⁸ See Letters from Financial Network and ING.

³⁹ 15 U.S.C. 78s.

applies only to the ‘natural person’ relationship.’” What is required by footnote 5 is that an associated person of a member not avoid the application of the firm’s business entertainment policies by claiming such entertainment is “personal” rather than business. Firms are, however, likely to include policies in their business entertainment procedures to address personal entertainment of a customer representative where there is a family or some other personal relationship, much the way firms do today for gifts and gratuities under Rule 3060 that are not in relation to the business of the employer of the recipient.

Many commenters requested clarification on whether an “independent” review could be conducted by an independent department within, or affiliated with, the member.⁴⁰ NASD has removed the specific review sections of the proposed rule change because it was redundant of existing obligations. A member firm’s responsibility to supervise business entertainment exists under Rule 3010(a), and a member firm’s responsibility to test and verify that its supervisory policies and procedures are achieving their intended purpose and complying with the federal securities laws and regulations and NASD rules exists under Rule 3012(a)(1).

Many commenters expressed concern with the breadth of the recordkeeping requirement and requested a lengthy implementation time for the recordkeeping requirements.⁴¹ In response to these comments, NASD provided an exception from the recordkeeping obligations for expenses under \$50. However, as discussed above, NASD believes that a member’s policies and procedures should prevent persons associated with the member from intentionally avoiding the \$50 requirement by breaking up what are otherwise connected costs or by engaging in frequent, repeated business entertainment at amounts below the \$50 threshold. For example, a firm’s

⁴⁰ See, e.g., Letters from Debevoise, Evolve, ICI, KBW, NRS, Transamerica Capital, and Wachovia.

⁴¹ See, e.g., Letters from Evolve, Financial Network, FSI, H.D. Vest, ICI, ING, Maplewood, and Transamerica Capital.

policies and procedures may require associated persons of the member to submit all business entertainment expenses for review; however, the firm may decide to record and track only amounts over \$50. NASD also is providing for an effective date of six months following the Commission's approval of the proposed rule change. Members should provide the Commission with specific comments as to whether this is sufficient time to implement recordkeeping systems to comply with the proposed rule change and, if it is not sufficient, offer reasons why and suggest an appropriate implementation period.

One commenter suggested that NASD permit a member's procedures to include prompt review of business entertainment after the event.⁴² The commenter offered an example of a dinner that unexpectedly exceeds the firm's threshold. NASD does not believe that a member's policies and procedures should allow for post-event approval because there does not appear to be an effective means of rescinding business entertainment that has already been provided. Rather, persons associated with a member who are concerned that the cost of an event may exceed the threshold should request approval in advance to go over the firm's limit. In such a situation, the member should impose another dollar limit rather than simply waive the requirement.

Finally, several commenters requested that NASD and the NYSE harmonize their proposed rule changes or, in the alternative, include a provision that a dual member that complies with one of the SRO's rule will be deemed to be in compliance with the other SRO's rule.⁴³ In filing this Amendment No. 1, NASD has sought to address substantive disparities between its rule and that of the NYSE.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within

⁴² See Letter from T. Rowe Price.

⁴³ See, e.g., Letters from BMA and SIA.

such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act.

The Commission notes that the NYSE's proposed Rule 350A(e) provides that a NYSE member organization must have a system in place to give notice (e.g., via the member organization's Web site, a disclosure document, or other appropriate means) to customers that use customer representatives that upon a customer's written request, the NYSE member organization will provide detailed information regarding the manner and expense of any business entertainment provided by the NYSE member organization to the customer representative,⁴⁴ while the NASD's proposal does not contain a similar notice provision.⁴⁵ The Commission is soliciting comment on this difference between the NYSE and NASD proposed rules and specifically whether NASD should have a similar notification provision for customers utilizing customer representatives.

Comments may be submitted by any of the following methods:

⁴⁴ NYSE believes 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. See supra note 5.

⁴⁵ See supra note 5.

Electronic Comments:

- Use the Commission's Internet comment form (www.sec.gov/rules/sro.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-NASD-2006-044 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASD-2006-044. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (www.sec.gov/rules/sro.shtml). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to

make available publicly. All submissions should refer to File Number SR-NASD-2006-044 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁴⁶

Florence E. Harmon
Deputy Secretary

⁴⁶ 17 CFR 200.30-3(a)(12).