

Phlx Memo No. 1259-07

RC No: NASD- 2006-44

MEMORANDUM

To: Members and Member Organizations

From: Legal Department

Date: May 24, 2007

Re: NASD Code of Arbitration
SR-NASD-2006-44 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 Phlx Rule 950, Section 44, the Exchange has outsourced its arbitration and mediation program to NASD Dispute Resolution. The purpose of this memo is to update you as to proposed amendments to the NASD Code of Arbitration Procedure.

National Association of Securities Dealers, Inc. ("NASD"), through its wholly owned subsidiary, NASD Dispute Resolution, Inc. ("NASD Dispute Resolution") filed with the Securities and Exchange Commission ("SEC" or "Commission") on April 11, 2006. On April 17, 2007, NASD filed Amendment No. 1 to the proposed rule change. On May 1, 2007, NASD filed Partial Amendment No. 2 to the proposed rule change. The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

NASD is proposing to adopt Interpretive Material ("IM") to NASD Rule 3060 to require members to adopt policies and procedures addressing business entertainment.

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." 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. In response to these requests, NASD is proposing interpretive material to NASD Rule 3060 to outline the policies and procedures that a member must adopt in connection with its business entertainment practices. 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. NASD has also clarified that any non-cash compensation falling under Rule 2820(g) or Rule 2830(I) would be subject to the standards imposed by those rules.

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." The proposed rule change is intended to replace this statement regarding business entertainment with an approach that permits each member to adopt 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. 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." 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.

Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

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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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, while the NASD's proposal does not contain a similar notice provision. 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:

Electronic Comments

- . Use the Commission's Internet comment form (<http://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 (<http://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 June 12, 2007.**

The text of the proposed rule change is available on NASD's Web site (<http://www.nasd.com>), at NASD's principal office, and at the Commission's Public Reference Room.

If you have any questions regarding this proposed rule change, or would like a complete copy of this proposed filing, or further questions regarding the NASD Dispute Resolution Process, please click on the NASD Dispute Resolution website at www.nasdadr.com. If you need additional help, please contact Scott Donnini at (215) 496-5358.