

Asset Management | March 27, 2008

At the Close of the Investigation that Started It All, an Update on FINRA's Gift and Entertainment Rulemaking

The Securities and Exchange Commission appears to have concluded its multi-year investigation of the gift and entertainment relationships between traders at Fidelity Management & Research and the brokerage firms executing Fidelity's securities trades. The agency did so with settlements with Fidelity, which agreed to an \$8 million fine, and with a number of the firm's traders and executives.¹ Ten more Fidelity traders will be defendants in a civil trial before an SEC administrative law judge.² The combination of the Fidelity name and the details offered about the lavish gifts and entertainment involved probably would have attracted media interest in any event, but the decision to bring (and settle) charges against legendary Fidelity Magellan Fund portfolio manager Peter Lynch assured front-page coverage.³

This high profile treatment can be seen as a regulatory "exclamation point" calculated to remind the industry of the fiduciary and ethical issues implicated by gift and entertainment abuses.¹ Accordingly, this alert uses the Fidelity settlements as a springboard to review a rule proposal that would require detailed new supervisory procedures around broker-dealer business entertainment. Although the proposal technically applies only to broker-dealers, the SEC commented several times in the Fidelity release on the inadequacy of Fidelity's gift and entertainment procedures, suggesting that investment

advisers need procedures in this area as well. Speeches by senior SEC staff likewise note the importance of policies and procedures relating to gifts and entertainment in the fund and adviser contexts.⁴

¹ In the matter of Fidelity Management & Research Company and FMR & Co., Inc., SEC Release No. IA-2713 (March 5, 2008), available at <http://www.sec.gov/litigation/admin/2008/ia-2713.pdf>. See also In the matter of Bart A. Grenier, SEC Release No. IA-2714 (March 5, 2008); In the matter of Marc C. Beran, SEC Release No. IA-2716 (March 5, 2008); and In the matter of Peter S. Lynch, SEC Release No. IC-28189 (March 5, 2008).

² In the matter of Scott E. DeSano, Thomas H. Bruderman, Timothy J. Burnieika, et al., SEC Release No. IA-2715 (March 5, 2008).

³ See, e.g., Kara Scannell, *Gifts Case Nabs a Star*, WALL ST. J., March 6, 2006, at C1.

⁴ For example, in a 2005 speech, Paul Royce, then Director of the SEC's Division of Investment Management, said, "There is no doubt that the receipt of lavish gifts and entertainment can influence fund personnel's actions, and even tempt fund personnel to take actions that may not be in the best interest of fund investors. Consequently, it is essential for advisers-and fund directors-to consider whether there are appropriate controls in place addressing the receipt of gifts and entertainment. A code of ethics is an appropriate place to outline a firm's philosophy regarding the receipt of gifts and entertainment as well as establish the controls the firm puts in place to limit the corrupting influence of such gifts." See Remarks before the Mutual Fund Directors Forum Fifth Annual Policy Conference: Critical Issues for Investment Company Directors (2005), available at: <http://www.sec.gov/news/speech/spch021705pfr.htm>.

Background to the Scandal – Looking Back a Year

In December 2006, the SEC and the National Association of Securities Dealers announced settlements with broker-dealer Jefferies & Co., Inc. for its role in providing many of the gifts and much of the entertainment at issue.⁵ Jefferies agreed to pay fines totaling \$9.6 million. That same month, the Board of Directors of the Fidelity Funds imposed a \$42 million penalty of its own, which Fidelity agreed to pay to the funds.⁶ Also by December 2006, none of the Fidelity traders at the heart of the scandal remained on the job. To an outside observer, the matter reasonably might have seemed closed at that point, with the participants publicly chastised and with millions of dollars paid as financial restitution. Indeed, coming more than a year later, the recent action against Fidelity was something of a surprise.

The Fidelity Settlements

The SEC's March 2008 release announcing the Fidelity settlements uses excerpts from dozens of emails and instant messages between Fidelity's traders and the outside brokers trading with them to paint a picture of an apparently runaway gift and entertainment culture. One after another, those messages show brokers pitching securities transactions to Fidelity traders while at the same time talking up the gifts and entertainment they had on offer; and the traders appeared to respond in kind, often directly soliciting the offers.

According to the release, gifts given to the traders include private jet charters, tickets to Wimbledon, the U.S. Open tennis tournament and various other high profile concerts and sporting events, as well as goods such as cases of expensive wine, humidors stocked with cigars, portable DVD players and – rather startlingly – illegal drugs. Entertainment included multiple-day golf outings, vacations for traders and their families, bachelor party expenses, and Super Bowl weekend festivities, all of which were accompanied by private jet charters and extravagant hotel accommodations.

The SEC values the bounty at over \$1.5 million, much of it flowing to a few highly favored traders. Overall, one is left with the impression of a *quid pro quo* relationship between the traders and the brokers, which the SEC characterized as a breach of the firm's fiduciary duty to its clients under the Investment Advisers Act of 1940 that “resulted in a substantial possibility of higher execution costs to [Fidelity's] advisory clients.”

What was the role of Mr. Lynch? He is alleged to have directed traders on several occasions to solicit tickets on his behalf, which the SEC viewed as an endorsement of the improper conduct on the trading desk. An SEC official said as much in remarks to the press:

The tone is set at the top. If higher-ups request tickets from a trading desk, it may send a message to the traders that such misconduct is tolerated and could contribute to the breakdown of the compliance culture on the desk.⁷

The Regulatory Response

Both the December 2006 settlements with Jefferies and the March 2008 settlement with Fidelity refer to the central role of a Jefferies trader named Kevin Quinn, who

⁵ Press Release, National Association of Securities Dealers, NASD Fines Jefferies & Company \$5.5 Million for Providing Improper Gifts and Excessive Entertainment to Fidelity Traders (Dec. 4, 2006); Press Release, Securities and Exchange Commission, Jefferies Settles SEC Charges Involving Illegal Gifts and Entertainment (Dec. 4, 2006). NASD Press Releases are available at www.finra.org, the Internet Website of the U.S. Financial Industry Regulatory Authority, the successor regulator to NASD.

⁶ Press Release, Fidelity Investments, Report and Conclusions of the Independent Trustees of the Fidelity Funds on Fidelity Traders' Receipt of Improper Travel, Entertainment, Gifts and Gratuities (Dec. 22, 2006), available at <http://personal.fidelity.com/global/content/independent-report.shtml>.

⁷ Kara Scannell, *Gifts Case Nabs a Star*, WALL ST. J., March 6, 2006, at C1, quoting SEC deputy director of enforcement Walter Ricciardi.

is alleged to have repeatedly violated NASD's⁸ gift rule, while being reimbursed by Jefferies throughout. The gift rule – NASD Conduct Rule 3060 – prohibits NASD members and their associates from giving anything exceeding \$100 in value per individual per year when the gift is related to the business of the recipient's employer.⁹ The rule also requires members to keep separate records regarding gifts and gratuities.¹⁰ Interestingly, the original investigation is said to have begun when a NASD examiner poring through just such an array of records questioned Jefferies' \$38,000 expenditure for tickets to the 2004 Wimbledon tennis tournament.¹¹

The NASD also conducted a targeted gift and entertainment review of 40 member firms from 2004 to 2006. That review led to a NASD report that described serious concerns with respect to supervisory procedures relating to Rule 3060.¹² According to the report:

- Many firms had no mechanism for determining when entertainment should be treated as a gift. They failed to keep records of whether their employees attended events for which the firms were spending thousands, or even millions, of dollars annually.
- Many firms had no mechanism to aggregate gifts given to individual recipients and therefore no way

to test compliance with the \$100 *per annum* cap on gifts to individuals.

- Most firms had difficulty providing examiners with gift and entertainment information, which was stored in different locations and formats with no centralized recordkeeping protocol.
- Firms relied heavily in responding to examiner requests on travel and expense reimbursement systems, which the NASD observed are not designed to assess compliance with Rule 3060 and often did not collect such information as recipient name and employer.
- While firms required supervisory gift approval, most processes focused on cost management rather than on regulatory compliance with the Rule 3060 parameters. The NASD commented that many firms did not require pre-approvals and that supervisors frequently approved gifts with insufficient recipient information and without considering aggregation.

That same year, the NASD issued a special Notice to Members 06-69 (Dec. 2006) addressing gifts and entertainment.¹³ We describe that Notice to Members below.¹⁴

Proposed IM-3060

To address concerns about “excessive” entertainment, the NASD proposed IM-3060, interpretive material that would require member firms to design and implement internal entertainment policies. The proposal has had a lengthy

⁸ Following its 2007 merger with the member regulation arm of the NYSE, the NASD is now known as FINRA, but since it was known as the NASD for most of the period at issue, and since the Conduct Rules are still referred to as the NASD Conduct Rules, we have elected to refer to FINRA as the NASD throughout this alert.

⁹ Rule 3060(a) states:

No member or person associated with a member shall, directly or indirectly, give or permit to be given anything of value, including gratuities, in excess of one hundred dollars per individual per year to any person, principal, proprietor, employee, agent or representative of another person, principal, proprietor, employee, agent or representative of another person where such payment or gratuity is in relation to the business of the employer of the recipient of the gratuity. A gift of any kind is considered a gratuity.

¹⁰ NASD Conduct Rule 3060(c).

¹¹ Ross Kerber, *N.Y. firm courted Fidelity traders with \$2m in gifts*, BOSTON GLOBE, Dec. 5, 2006.

¹² NASD REPORT ON EXAMINATION FINDINGS REGARDING GIFTS AND GRATUITIES (2006), available at http://www.finra.org/web/groups/rules_regs/documents/rules_regs/p018025.pdf.

¹³ NASD Notice to Members 06-69 (Dec. 2006), available at http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p018024.pdf.

¹⁴ Prior to that activity, the most recent NASD interpretive guidance on the subject was in 1999. Letter from R. Clark Hooper, NASD Executive Vice President, to Henry H. Hopkins, Director and Sarah McCafferty, Vice President, T. Rowe Price Inv. Servs. (June 10, 1999) (stating that “ordinary and usual business entertainment” is outside Rule 3060's scope), available at <http://www.finra.org/RulesRegulation/PublicationsGuidance/InterpretiveLetters/ConductRules/P002715>.

history, going through several amendments prior to its current iteration as filed with the SEC on January 2, 2008.¹⁵

IM-3060 will not become effective until one year following its still-pending final approval by the SEC. Even if never finalized, IM-3060 stands as the most recent regulatory guidance in this area and deserves attention.

Rules for Gifts

Because gifts are limited to \$100 while entertainment is not, IM-3060 is largely focused on entertainment, rather than on gift giving practices. But the principle underlying IM-3060 – the need “to ensure that a member or its associated persons do not do or give anything of value to an employee of a customer that may cause (or appear to cause) the customer’s employee to act in a manner that is inconsistent with the customer’s best interests”¹⁶ – is equally applicable to gifts. Gift giving practices also were covered in detail in Notice to Members 06-69. According to that Notice to Members:

- **Personal Gifts, De Minimis Gifts and Other Exclusions from Rule 3060.** Personal gifts, such as wedding gifts or congratulatory gifts for the birth of a child, do not fall under Rule 3060’s ambit, provided that such gifts are not “in relation to the business of the employer of the recipient.” If a firm bears the cost of a gift (either directly or through reimbursing an employee), the NASD will presume the gift is not “personal” and relates to the business of the recipient’s employer.¹⁷

¹⁵ The rulemaking history of IM-3060 is available at <http://www.finra.org/RulesRegulation/RuleFilings/2006RuleFilings/P016355>.

¹⁶ NASD Notice to Members 06-06 (Jan. 2006), available at <http://www.finra.org/RulesRegulation/NoticestoMembers/2006NoticestoMembers/P015877>.

¹⁷ In separate guidance, an exception to the \$100 limit on the value of gifts has been permitted for “reasonable and customary bereavement gifts.” Letter from Gary Goldsholle, NASD Vice President and General Counsel, to Amal Aly, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association (Dec. 7, 2007), available at <http://www.finra.org/RulesRegulation/PublicationsGuidance/InterpretiveLetters/ConductRules/P037695>.

Rule 3060 also does not apply to gifts of *de minimis* value (such as pens, notepads, or modest desk ornaments) or to promotional items of nominal value that display the firm’s logo (such as umbrellas, tote bags, shirts, etc.). To be classified as *de minimis*, the gift must have a value “substantially below” the \$100 gift limit.

Rule 3060 also does not apply to gifts commemorating business transactions (such as Lucite tombstones, plaques, etc.), even when these items cost more than \$100.¹⁸ These gifts must be decorative only; items with other uses trigger Rule 3060 restrictions.

- **Gifts Incidental to Business Entertainment.** Gifts given in the course of business entertainment and conferences are not excluded from Rule 3060 restrictions, recordkeeping requirements, or aggregation obligations. For example, an umbrella given at a golf outing is subject to Rule 3060 (unless the *de minimis* exclusion is available).
- **Valuation and Aggregation of Gifts.** Gifts should be valued at the higher of cost or market value, exclusive of tax and delivery charges. When a member firm gives a gift to multiple recipients, the giver should record the names of each recipient and calculate and record the value of the gift for each recipient on a *pro rata* basis. Member firms must aggregate all gifts given to a particular recipient over the course of a year.
- **Policies and Procedures.** Member firms should maintain supervisory procedures for their gift giving practices. Procedures recommended by Notice to Members 06-69 include (i) a means to catalog, and aggregate, gifts given on a per recipient, *per annum* basis, which implies a detailed and centralized reporting process, and (ii) a means to review gift giving that is claimed as covered by the exclusions for personal, *de minimis* or business commemoration

¹⁸ The NASD’s focus here is not on the item’s *cost*, but its *value*. The NASD presumes that solely decorative items “are not items of value” as defined in Rule 3060.

gifts (that review process should involve personnel other than the giver of the gift). The NASD also expects firms' procedures to provide for training employees and distinguishing gifts from entertainment.

Rules for Entertainment

Under IM-3060 as proposed, the NASD employs a "principles-based" approach to regulation of business entertainment – with the first principle being that NASD members should be allowed to set their own entertainment policies, but should "compete for business on the basis of providing the best professional services," not by outspending each other on entertainment.¹⁹ The NASD contemplated moving away from that approach in favor of imposing limits on entertainment expenses (much like the \$100 cap on gifts), but decided that any one-size-fits-all standard would be "unworkable and impractical."²⁰ Instead, proposed IM-3060 would establish a standard of conduct and require member firms to develop procedures around it.

- **IM-3060's Proposed Standard of Conduct.**

IM-3060 would prohibit a member firm or its associated persons from providing business entertainment to a representative of the firm's current or prospective customers 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.

- **Who Is a "Customer" for this Purpose?** So as to include both current and prospective customers, IM-3060 would define a firm's "customer" as:

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

- **What Is "Business Entertainment" and What Is a "Gift" for this Purpose?** IM-3060 would define "business entertainment" broadly as:

Any social event, hospitality event, sporting event, entertainment event, meal, leisure activity, or event of like nature or purpose regarding an existing or prospective customer relationship, 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 appropriate associated person of a member accompanies a customer representative.²¹

By way of contrast:

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.

¹⁹ See SR-NASD-2006-44, "Proposal to Adopt New IM-3060 to Require Members to Adopt Written Policies and Procedures Concerning Business Entertainment" (April 11, 2006), at 36.

²⁰ *Id.* at 12. See also Susanne Craig, *Party Tab: Wall Street to Set Limit on Gifts*, WALL ST. J., Jan. 24, 2006, at C1 (describing the possibility of hard NASD caps as a measure to define "excessive" entertainment expenses).

²¹ A firm's 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 other requirements of IM-3060 and are "explicitly addressed" in the policies and procedures.

- What if an Associated Person Plans to Attend the Business Entertainment Event, but Fails to Do So?
 In that event, the planned business entertainment would become a “gift,” subject to an exception from that outcome for “exigent circumstances” that “make it impractical” for the associated person from attending the event as planned. Examples of “exigent circumstances” offered earlier in the NASD rulemaking process include caring for a sick child, experiencing an accident or confronting some other sudden, overriding circumstances.²² All instances of exigent circumstances should 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 prompt and documented post-event review.
- Policies and Procedures (Generally). IM-3060 would require each member to assess its use of business entertainment, determine what limitations are appropriate and adopt written policies and procedures to ensure that associated persons follow those limitations. These policies and procedures should:

 - (1) be 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;
 - (2) require appropriate training and education for all personnel who supervise, administer, or are subject to the written policies and procedures;
 - (3) make clear that anything of value given or otherwise provided to a customer that does not fall within the definition of “business entertainment” is a gift under Rule 3050; and
 - (4) specify a methodology for valuing gifts and entertainment, which, in general, should be the higher of face value or cost to the member.
- Policies and Procedures (Relating to Institutional Customers). Because the NASD believes that the risks of abuses are more likely for these customers, additional requirements apply to a member firm’s policies and procedures relating to business entertainment provided to *institutional customers* (defined as customers that meet the definition of an “institutional account” in Rule 3110(c)(4), i.e., banks, insurance companies, registered investment companies, registered investment advisers or persons with total assets of at least \$50 million). These more elaborate policies and procedures should:

 - (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) require the maintenance of detailed records of business entertainment expenses provided to any customer representative of an institutional customer and must include provisions reasonably designed to prevent associated persons from circumventing the recordkeeping requirements in contravention of the spirit and purpose of IM-3060 (such that recording business entertainment for institutional customers must become an ingrained habit in the business); and
 - (4) require that, upon an institutional customer’s written request, the member will promptly make available to the institutional customer any

²² NASD: Business Entertainment, SEC Release No. 34-55675, 72 Fed. Reg. 28744 (2007).

business entertainment records regarding business entertainment provided to customer representatives of that institutional customer.

- **Partial Exemption for Members with Business Entertainment Expenses Below \$7,500.** IM-3060 would exempt a firm from most aspects of IM-3060 (but not from IM-3060's standard of conduct) if the firm has less than \$7,500 in business entertainment expenses during the relevant fiscal year. The only recordkeeping that would be required is that necessary to document eligibility for the exemption.

Special Rules for Governmental Actors and Pension Plans

None of the NASD materials discussed above distinguish governmental actors or pension plans from other recipients of business gifts and entertainment, but special risks and rules apply in those areas. While a detailed, jurisdiction-by-jurisdiction discussion is beyond the scope of this alert, in many cases the rules may be more stringent than those promulgated by the NASD.

By way of example, the State of New York bans gifts to public employees and public officials of more than nominal value “unless under circumstances in which it cannot be inferred that the gift was intended to influence or reward the recipient for performing official duties.”²³

²³ New York State Ethics Commission: Ethics in State Government, a Guide for New York State Employees, available at <http://www.dos.state.ny.us/ethc/eisg.html>.

Also by way of example, the U.S. Department of Labor, which regulates corporate pension plans, takes an increasingly hard line in considering gift and entertainment practices, with its field examiners advising plan trustees and plan service providers that they have “zero-tolerance” for inappropriate practices in this area. That zero-tolerance assertion prompted the Securities Industry and Financial Markets Association and the Investment Adviser Association, acting jointly, to ask the DOL to provide specific guidance on the topic and, ideally, to reaffirm that reasonable and customary business entertainment is permitted.²⁴ The DOL has yet, however, to respond to that request.

Conclusions

The proposed FINRA guidance is notable for a number of reasons: First, the adoption of IM-3060 will place the responsibility for ensuring the reasonableness of gifts and business entertainment squarely on the shoulders of broker-dealers. Second, IM-3060 represents an important example of principles-based regulation on the part of U.S. securities regulators. Finally, in acting to place regulatory focus and compliance requirements on gifts and entertainment, FINRA sets a standard against which other market participants, such as funds and advisers, likely will be measured.

²⁴ Letter to Bradford Campbell, Assistant Secretary, Employee Benefits Security Administration, U.S. Dept. of Labor, from SIFMA Vice President and Director for Retirement Policy Elizabeth Varley and IAA General Counsel Karen Barr (Oct. 4, 2007), available at http://www.sifma.org/regulatory/comment_letters/55159220.pdf.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

For more information on the topics covered in this issue, please contact:

Nathan J. Greene
New York
+1.212.848.4668
+1.646.848.4668 fax
ngreene@shearman.com

Paul S. Schreiber
New York
+1.212.848.8920
+1.646.848.8920 fax
pschreiber@shearman.com

Charles S. Gittleman
New York
+1.212.848.7317
+1.212.848.4039 fax
cgittleman@shearman.com

Russell D. Sacks
New York
+1.212.848.7585
+1.646.848.7585 fax
rsacks@shearman.com

M. Holland West
New York
+1.212.848.4579
+1.646.848.4579 fax
holland.west@shearman.com