

NYSE and NASD Propose New Requirements for Business Entertainment Expenses

May 31, 2007

The New York Stock Exchange LLC (NYSE) and the National Association of Securities Dealers, Inc. (NASD), are proposing to amend their respective rules to clarify the requirements relating to business entertainment provided by their members, member organizations, and member firms (collectively, “Members”).¹ The Proposed Rules will become effective six months after they have been approved by the Securities and Exchange Commission (SEC).² A summary of the Proposed Rules is set forth below.

I. General Requirements of the Proposed Rules

The Proposed Rules generally provide that Members, and persons associated with Members, may not provide business entertainment to customer representatives in connection with a proposed or existing customer relationship if such entertainment is intended or designed to cause, or would be reasonably judged to have the likely effect of causing, the customer representative to act in a manner that is inconsistent with the best interests of the customer or the best interests of any person to whom the customer owes a fiduciary duty. The Proposed Rules would apply to all business entertainment provided by a Member, even if such entertainment occurs outside of the United States or is provided to foreign individuals.

The term “business entertainment” is defined broadly 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....” With the exception of situations when exigent circumstances make it impractical, the Proposed Rules require an associated person of a Member to accompany or participate in an event for it to be deemed “business entertainment.”³

A “customer representative” is defined as “a person who is an employee, officer, director, or agent of a customer, unless such person is a family member of the customer,” and thus includes persons who may not be employees of the customer. The exclusion for family members is designed 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 parent’s account).

II. Application of the Proposed Rules to Members’ Affiliates

On their face, the Proposed Rules apply to Members and persons that are associated with Members. This raises the question, however, of whether the Proposed Rules should be read to cover business entertainment provided by persons who are employed by an affiliate of a Member but are supervised by, or report to, an associated person of a Member (an “Affiliated Employee”). The NYSE and NASD have clarified that an Affiliated Employee would not be deemed to be an associated person of a Member under the Proposed Rules solely because that person is managed or supervised by an associated person of a Member. Moreover, they have taken the position that the Proposed Rules will not apply to an Affiliated Employee if:

- The manager/supervisor of that Affiliate Employee is recognized in the organization as having responsibilities outside of the Member;
- The exercise of the management and supervision over that Affiliated 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

- The Affiliated Employee is not otherwise employed or engaged in the investment banking or securities business of the Member or controlled by the Member in respect of such activities.

III. Written Policies and Procedures

The Proposed Rules will require Members to adopt written policies and procedures that:

- Define forms of business entertainment that are appropriate and inappropriate, using quantitative 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;
- Impose either specific dollar limits on business entertainment or require advance written supervisory approval beyond specified dollar thresholds;
- 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;
- Establish standards to ensure that persons designated to supervise and administer the written policies and procedures are sufficiently qualified;⁴ and
- Require appropriate training and education for all personnel who supervise, administer, or are subject to the written policies and procedures.

The Proposed Rules would permit, but not require, Members to establish different standards for business entertainment in connection with events that are educational, charitable, or philanthropic in nature. Moreover, if a Member chooses to distinguish between forms of business entertainment in its policies and procedures, it must ensure that these forms of business entertainment comply with the general requirements set forth above.

IV. Recordkeeping

Under the Proposed Rules, a Member's policies and procedures would be required to include procedures regarding the

maintenance of detailed records of business entertainment expenses provided to any customer representative. In order to minimize this burden, the Proposed Rules provide that members are not required to maintain records of: (a) business entertainment expenses 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 expenses that do not, in the aggregate, exceed \$50 per day. Members may not, however, disaggregate business entertainment expenses relating to an activity or event in an effort to avoid their recordkeeping obligations. The Proposed Rules also would require Members to provide information to any requesting customer regarding the business entertainment that the Member has provided to that customer's representative.⁵

V. Exemption for Members with Minimal Business Entertainment Expenses

For Members that do not devote significant resources to business entertainment, the Proposed Rules provide limited exemptions. In particular, Members with annual business entertainment expenses below \$7,500 are exempted from the recordkeeping requirements and some of the requirements to keep written business entertainment policies and procedures.⁶ Members that fall within this exemption, however, must still comply with the general requirements of the Proposed Rules, and must have limited written policies and supervisory procedures that are designed to detect and prevent business entertainment that: (a) is an improper quid pro quo, (b) gives rise to a potential conflict of interest, or (c) undermines the performance of a customer representative's duty to a customer. Members that qualify for this exemption also must establish standards to ensure that persons designated to supervise and administer such policies and procedures are sufficiently qualified.

VI. Comments and Questions

Comments on the Proposed Rules should be submitted to the SEC on or before June 12, 2007. The Proposed Rules may be found at <http://www.sec.gov/rules/sro/nyse/2007/34-55766.pdf> and at <http://www.sec.gov/rules/sro/nasd/2007/34-55765.pdf>.

- 1 See Securities Exchange Act Release No. 55,766 (May 15, 2007) (the “NYSE Proposal”), which proposes new NYSE Rule 350A, and Securities Exchange Act Release No. 55,765 (May 15, 2007) (the “NASD Proposal”), which proposes Interpretive Material to existing NASD Rule 3060 to be labeled as IM-3060. The changes described in the NYSE Proposal and the NASD Proposal shall be referred to herein as the “Proposed Rules.”
- 2 The NASD will announce the effective date of the NASD proposal in a Notice to Members to be published no later than 60 days following SEC approval.
- 3 It is important to note that any item of value provided to a customer representative that does not fall within the definition of “business entertainment” will be deemed to be a gift. Because existing NYSE and NASD rules impose strict dollar limitations on gifts, Members should carefully consider whether their business entertainment activities constitute “business entertainment” under the Proposed Rules.
- 4 This “sufficiently qualified” requirement does not necessarily suggest or impose a specific registration requirement or similar obligation on these individuals.
- 5 Although the NYSE Proposal and the NASD Proposal are almost identical, the NYSE Proposal would require NYSE Members to have a system in place, such as a web site, through which they will provide detailed information relating to the manner and expense of any business entertainment provided to their customer representatives. The NASD Proposal does not contain a similar provision. The SEC is soliciting comments on this difference between these two Proposals.
- 6 This \$7,500 threshold must be measured on a fiscal year basis, and each Member that relies on the exemption must evidence that its business entertainment expenses were below this threshold.

If you have any questions about this information, or would like to receive a copy of the Proposed Rules, please contact one of our practice partners listed below:

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