
by Kurt J. Decko

Until recently, the receipt of gifts and entertainment by employees of investment advisers garnered little attention from regulators and the media. With news reports revealing bachelor parties and the like financed by brokers, investment advisers are reevaluating existing gifts and entertainment policies and procedures (or adopting new policies and procedures) in heightened recognition of the need, to minimize not only any potential conflicts

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Gifts and Entertainment Policies

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of interest, but also the appearance of such conflicts with the brokers and other service providers with which the adviser conducts business. Indeed, the appearance of conflicts of interest is often, from a reputational viewpoint, as harmful as actual conflicts of interest. The reevaluation of gifts and entertainment policies also provides advisers the opportunity to remind employees of the adviser’s business standards.

As there is no such thing as a “model” or “standard” gifts and entertainment policy for advisers, and little directly applicable regulatory authority on the topic, this article seeks to provide guidance on the evaluation and implementation of an effective policy. It highlights a number of provisions and issues that investment advisers should, at a minimum, consider in reevaluating their policies. While each adviser must tailor its policy to its particular organization to be truly effective (with variances depending on the size, structure and business activities of the adviser and its affiliates), gifts and entertainment policies normally include several common elements. Structurally, effective policies contain clear and precise limitations on employees accepting gifts and entertainment. Generally, these limitations (the scope of which is discussed subsequently) are broad, usually with narrowly tailored exclusions based on specific situations in which potential conflicts of interest would not arise or can be effectively monitored. Just as critical as a clear and articulate policy is the method by which the policy is implemented. In this regard, most advisers consider reporting and pre-clearance requirements as useful tools for monitoring compliance.

While the task sounds simple—forbid employees from accepting certain gifts and entertainment and check to see if they follow the policy—numerous complications arise in trying to impose restrictions that are not always intuitive and can, at times, alter established business practices. Few internal regulating policies (with the exception of limitations on personal trading) potentially impact the personal activities of employees as limitations on gifts and entertainment, particularly for trading room and investment personnel, as well as, in some cases, individuals engaged in marketing the adviser’s investment services and products.

In the personal trading context, employees know (or should know) that investing based on inside information is inherently wrong and if they do not know this, they at least understand that the activity could very well put them in jail. By contrast, how does an employee know where to draw the line on accepting gifts and entertainment given the need to develop business relationships and the inevitable intertwining of personal and business relationships? Certainly, accepting quid pro quo gifts is (or should be) obviously wrong—as are bribes. Rarely, however, is anything expressly conditioned on the gift. What is the harm, an employee may think, in accepting a free iPod, an invitation to a celebrity golf tournament, or scarce Super Bowl tickets? If a broker or other vendor has already paid for the gift, why not take advantage of the opportunity as a perk of the job? Even more blurry, what if the gift-giver is a personal friend or member of an extended family? A number of ancillary issues also arise: When reporting the receipt of Super Bowl tickets, is the proper value the $100 printed on the face of the tickets or the $2000 that can be fetched for them on eBay? Advisers are also considering whether to restrict employees from giving gifts and entertainment to others to the same extent as receiving or whether a different standard should apply to giving in light of competitive pressures that may include gift-giving or sponsoring entertainment as an integral part of the adviser’s overall marketing activities. These are all valid questions for which employees need guidance, and the regulatory and media attention focused on gifts and entertainment policies further underscore the need for clear and articulate written policies and procedures on the topic.

The Legal and Regulatory Background

Gifts and entertainment policies are not expressly mandated by the compliance and codes of ethics rules of the Securities and Exchange Commission (SEC) under the Investment Advisers Act of 1940, as amended (Investment Advisers Act), or, for investment advisers to registered investment companies, under the Investment Company Act of 1940, as amended (Investment Company Act). Nonetheless, accepting gifts and entertainment can create serious conflicts of interest or, often just as significant, the appearance of such conflicts. As noted in a speech by the then-Director of the SEC’s Division of Investment Management in early 2005, “[t]here 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.” Thus, it is with some peril that an investment adviser relies on the absence of an
express mandate for gifts and entertainment policies to fail to adopt such policies.

Developing an effective gifts and entertainment policy is particularly difficult in the absence of regulatory guidance as to "best practices" in the area. Some guidance can be found from analogous provisions of the National Association of Securities Dealers, Inc. (NASD) Code of Conduct applicable to NASD-member firms, including mutual fund underwriters. Notably, NASD Conduct Rule 2830(l) regulates cash and non-cash compensation arrangements in connection with the sale and distribution of investment company securities. The NASD has recently issued, for comment, proposed interpretive material to NASD Conduct Rule 3060 that restricts broker-dealers from improperly influencing or rewarding employees of others. The proposed interpretive material specifically addresses gifts and business entertainment and reflects the renewed regulatory interest in the subject. NASD regulations provide helpful guidance concerning the appropriate manner to conduct business and directly regulate organizations with which the adviser conducts business. However, these provisions are usually not directly binding on advisers, unless they are dually registered as broker-dealers but may be applicable to any affiliated broker-dealer of the adviser.

The receipt of gifts and business entertainment by employees of advisers to registered investment companies, if extremely lavish or extensive, could result in violations of Section 17(e) under the Investment Company Act, which limits the nature and extent of compensation received by affiliated persons of registered investment companies in connection with the purchase or sale of securities on behalf of such investment companies. Even if the adviser does not provide services to registered investment companies, the failure to disclose receipt of such compensation may violate Section 206 of the Investment Advisers Act and other antifraud provisions of the federal securities laws. One way to protect the adviser and its employees from potential liability involving the exchange of gifts and entertainment by the adviser's employees is to develop, monitor and enforce a gifts and entertainment policy. At the very least, effective implementation of such a policy can insulate the adviser from a charge of failing to supervise its employees.

The Benefits of Gifts and Entertainment

Business entertainment and gifts can and do serve legitimate and valuable business purposes. It may sound like a cliché, but often business deals are made over meals and relationships are developed on the golf course. All else being equal, purchasers prefer to conduct business with an individual they trust and have a personal connection with rather than someone they barely know except over the phone, especially in service industries. Qualities such as responsiveness and character are important to forming lasting and meaningful business relationships and often these qualities are justifiably developed and evaluated away from the trading desk and outside of the conference room. Indeed, with the proliferation of email and the growing impersonalization of business, the personal relationships that flow from business meals and entertainment may be of more value than in the past. Regardless, this article does not attempt to delve into the psychological aspects of business relationships, but assumes that there are more than minimal potential benefits in allowing at least some business entertainment and gifts. This principle is similarly recognized by NASD, as the provision of business entertainment and gifts by NASD-member firms is not prohibited outright, but is rather carefully regulated.

First Step for Evaluating a Gifts and Entertainment Policy:

Talk with Employees

In order to properly develop a gifts and entertainment policy, the adviser should involve at the outset, as reasonably practical, as many employees directly affected by the policy as possible, especially trading room employees and investment personnel, i.e., those most likely to receive gifts and business entertainment. This involvement could take the form of questionnaires, but preferably interviews and group meetings. Only by involving affected personnel can the adviser gauge the practical application of the policy and learn about employee concerns, including how their every-day business practices would be impacted by any proposed changes to the policy. The adviser benefits from the process, as it can learn how to best tailor the policy to its particular circumstances. To be sure, interviews and conferences will not draw out every issue, and unanticipated issues will arise. However, to the extent issues can be anticipated and resolved in advance (backed with the considered thought of the adviser's decisionmakers), the guidance will be considerably more valuable in applying the policy in a consistent and principled manner.

The most significant benefit accruing from the involvement of affected personnel is that the policy can be drafted so that it will actually work
in practice. Discussions with personnel will reveal to what extent employees are aware of and adhere to existing policies (indicating whether additional or more targeted training efforts are warranted). It is of little or no use to enact a gifts and entertainment policy if it is not followed. Indeed, in many instances it is worse for the adviser to have a policy that is ignored or thwarted in practice than to have no policy at all. This is not to say that the policy should merely codify current practices if they are deficient. Rather, policies should be drafted and behavior modified in a realistic and pragmatic manner. For example, as business entertainment invitations frequently arise at the last minute, requiring pre-clearances without reasonable exceptions may only encourage non-compliance. To deal with such instances, advisers should seek to develop, in conjunction with affected personnel, reasonable and practical approaches to address common situations. Moreover, when implementing the reporting or pre-approval requirements noted subsequently, advisers often utilize, to the maximum extent possible, available technologies to facilitate compliance with the requirements.

Specific Provisions of an Effective Gifts and Entertainment Policy

The essential question for each adviser is where to draw the line between appropriate and inappropriate gifts and entertainment. Drawing such a line is not a simple process and many factors go into the evaluation. Short of a bribe or the explicit quid pro quo situation, there is a large grey area, and it is in this area where the guidance furnished by an adviser’s policies and procedures is invaluable. As such, policies usually contain both a general policy statement and specific and, to the extent feasible, objective criteria for determining whether particular gifts or entertainment are permissible. Examples illustrating appropriate and inappropriate conduct often help clarify expectations, whether as part of the policy or in the form of an explanatory Q & A or otherwise, with the most obvious example prohibiting quid pro quo situations. Employees should be expressly encouraged to seek guidance whenever a questionable situation arises, and cautioned that the appropriateness of gifts or business entertainment often will be measured with the benefit of hindsight. Certain specific provisions and guidelines commonly found in gifts and entertainment policies are discussed later in this article.

Policy Statement

Almost universally, gifts and entertainment policies begin with a discussion of the principles behind the policy and the general business standards (at least concerning gifts and entertainment) the adviser expects employees to follow. Essentially, the gifts and entertainment policy communicates to employees that they should not accept inappropriate gifts, favors, entertainment, special accommodations, or other things of material value that could influence their decisionmaking or make them feel beholden to a person or firm. The NASD code of business conduct is informative (even if not directly binding) and many policies at the outset similarly encourage employees to strive to achieve “high standards of commercial honor and just and equitable principles of trade,” as reflected in the NASD code.

Cash

Most policies flatly prohibit accepting cash gifts or cash equivalents (checks, lottery tickets, gift cards redeemable for cash, etc.) from a client, prospective client, or any entity that does business or seeks to do business with the adviser. While gifts arguably can play an appropriate role in establishing a beneficial business relationship, a cash gift raises the specter of a kickback or a bribe, which would clearly be inappropriate.

Gifts

Most policies include a general restriction, subject to enumerated exceptions (discussed subsequently), on accepting any gift, service, or other thing of more than de minimis value from a client, prospective client, or any entity that does business or seeks to do business with the adviser. The clearest policies provide (either in the policy or in related explanatory materials) examples, depending on the nature of the adviser’s business, of acceptable or unacceptable gifts in order to better remind employees of the breadth of the restriction (meals, event tickets, travel, lodging, golf tournaments, wine, clothing, services, charitable donations on another’s behalf, etc.). Conceptually, a gift is any thing of value that would not be includable as business entertainment. Tangible objects—wine, clothing, physical items—are clearly gifts. The more difficult questions arise when entertainment is involved, with a classic example being tickets to an event.

To quantify the general restrictions concerning
gifts, most policies delineate a specific \textit{de minimis} value for acceptable gifts. The specific amount may vary depending on the nature and location of the adviser and its clients, but several advisers (regardless of location) use a $100 annual gift \textit{de minimis} value for all employees. The $100 annual limit is derived from NASD Conduct Rules 2830(1) and 3060.\textsuperscript{13} Accordingly, absent more specific guidance from the SEC, the $100 standard has rapidly become the \textit{de facto} general standard for permissible gifts across the financial services industries.

Related to the limitations on accepting gifts, many policies also prohibit employees from soliciting gifts or anything of value for themselves or for the adviser. To some extent, a prohibition on soliciting gifts necessarily would be subsumed by restrictions concerning the acceptance of gifts (why would an employee ask for something that they would be unable to accept), but it nevertheless is appropriate to clarify that solicitation in and of itself is not condoned. This concept is sometimes expressed as a prohibition on using one’s position with the adviser to obtain anything of value from a client, prospective client, or any entity that does business or seeks to do business with the adviser.

**Business Entertainment**

Although some policies apply the same standards to both gifts and business entertainment, more frequently there are different limitations on business entertainment in recognition of the greater role that business entertainment serves in fostering relationships. Specific to business entertainment, policies often contain a restriction on accepting extravagant, lavish, or excessive entertainment from a client, prospective client, or any entity that does business or seeks to do business with the adviser. The value of business entertainment can be limited to the same value as the gift policy or, as is often the case, a higher amount, so long as that amount is not extravagant or excessive (the amount may be influenced by the adviser’s location, as a meal in New York City costs more than in most other locations). Business entertainment sometimes excludes related out-of-town transportation and lodging expenses,\textsuperscript{14} because such expenses could reasonably be categorized as gifts instead.

Business entertainment restrictions usually extend beyond simply prohibiting illegal activities. The adviser may also restrict activities that, although not illegal, could harm the adviser’s reputation if it is learned that its employees engage in such activities. The policies that provide the best guidance set forth specific examples of entertainment that the adviser considers inappropriate for it to, in effect, sanction by permitting employees to engage in the activity in connection with adviser-related business. Further detail is often provided in terms of appropriate venues, nature of events, frequency of events, and types and class of accommodation and transportation related to the event (if determined to be business entertainment).\textsuperscript{15} Some policies also set forth different guidelines for charitable, educational or philanthropic events.

**Business Entertainment versus Gift**

What is and what is not business entertainment, as opposed to a gift, is not always clear, but a frequently utilized distinction is whether persons from the firm providing the entertainment who are relevant to the business relationship attend the event. For example, receiving tickets to a baseball game, which is not attended by the giver or anyone who is relevant to the business relationship, would be characterized as a gift; whereas receiving a ticket to the same game attended by the giver would be characterized as business entertainment. The NASD has proposed using a similar standard in the NASD Gifts and Entertainment Notice by defining “business entertainment”\textsuperscript{16} as providing entertainment “in which a person associated with a member accompanies and participates with such employee irrespective of whether any business is conducted during, or is considered attendant to, such event.”\textsuperscript{17} A further distinction made in some policies is that for the event to qualify as business entertainment there must be a business purpose for the event. For example, attending the opera at which the person paying for the ticket sits three aisles away and the business associates never speak all night might be considered a gift, whereas if the business relationship is discussed at a dinner preceding the opera a different conclusion could be reached. The drawback with such a distinction is that, in practice, it would be very difficult to monitor and enforce. Regardless of how the adviser determines to distinguish business entertainment from gifts, the distinction should be clearly articulated in the policy and consistently applied in practice.

**Valuation Issues**

One of the trickier details of a gifts and entertainment policy involves the valuation of items. In this respect, effective policies contain guidance on how to determine the value of a gift or busi-
business entertainment, and consistently apply such determinations. In many instances, value is apparent (tickets to a routine event have a face value printed on the ticket, hotel lodging is provided at a known rate; greens fees are ascertainable). In other situations, however, the value may not be known (in which case it may be, justifiably, awkward for an employee to inquire as to the cost of an item) or the item may have value as a unique or hard to acquire item (Super Bowl tickets, exclusive tours, etc.).

One useful manner to address valuation concerns is to provide that routine items be valued at cost, while items with unknown or special value be valued at market rates or pursuant to good faith estimation. In the latter cases, although administrative costs may increase, some mechanism often exists to assist the employee in making valuation estimates. For example, in conjunction with the reporting element discussed subsequently, a policy may provide for supervisory review of the basis for any estimated valuation (in essence allowing supervisory or compliance personnel to audit the valuation). Some policies provide examples and specifically address difficult valuation issues, such as whether private air transportation should be valued at the cost of a first class commercial ticket or whether valuation of an invitation to participate in a celebrity golf tournament must include a proportionate percentage of celebrity appearance fees. Further examples can be gleaned from discussions with affected personnel (derived from past experiences), but whatever valuation decisions are ultimately implemented should be drafted as clearly as possible to guide employees (and supervisors).

Exclusions

As illustrated, the limitations on gifts and entertainment often are broadly stated. As a general matter, they relate to at least some situations in which there are limited or no conflicts of interest. In these instances, specific types of gifts and entertainment are carved out and excluded from the policy’s requirements, often developed in consultation with affected employees. The guiding principle is whether the proposed exclusion offers the potential for abuse and whether that potential can be addressed in a different manner, for example, by requiring reporting.

Common examples of items that many policies specifically exclude (whether from the policy as a whole or from a reporting requirement) include small promotional items with prominent corporate logos—the risk that employees would forego their duties to clients for a pen would seem minimal in light of the paperwork that would be generated to report receipt of such an item. A meal that is necessitated by business obligations is also sometimes excluded (for example, when an employee spends the day conducting business at a vendor’s office and has meals with the vendor’s personnel). Another excludable category appearing in some policies is the receipt of certain discounts or rebates from counterparties. In order to prevent abuse, however, an appropriate qualifying limit can be imposed (i.e., the discount or rebate must not exceed those known to be available to classes of other customers).

Family and Friends

Another difficult issue to resolve in formulating a gifts and entertainment policy concerns the receipt of gifts or entertainment from family or individuals with close personal relationships. This issue is perhaps the most personally invasive. When evaluating the gifts and entertainment policy, it is necessary to recognize that the financial services industry can be a rather small world and often close family (spouses/siblings), extended family or personal friends work for entities that do business with the adviser. In such instances, strict application of the policy would impose intrusive regulation on the exchange of gifts between family members and close personal friends (such as Christmas or wedding presents), where the exchange of the gift is a by-product of the personal relationship. Moreover, the potential conflicts of interest inherent in close personal relationships derive not from the exchange of gifts, but from the relationship itself (in other words, the adviser’s concern is that an employee may direct trades to a best friend at a broker not because of an expensive gift, but because they are best friends). Given the variety of personal relationships, it is difficult to develop hard and fast rules governing conduct based solely on a categorization of relationships. Thus, many advisers find it useful to primarily focus on disclosure of the nature of the relationship and the parties involved so that potential conflicts of interest can be monitored by supervisory personnel—in many respects, the benefits of reporting have less to do with regulating actual gifts, but from understanding the nature and extent of the relationship.

Policies address the issue of gifts and entertainment between family and friends in different ways. Some exclude, categorically, gifts and entertain-
ment exchanged between persons in certain types of relationships (or, conversely, make no exclusions at all); others make an exclusion conditioned on proper reporting of the gift or entertainment or of the relationship. For example, some policies fully exclude gifts and entertainment given and accepted if based on personal, rather than business, motivations, but the breadth of the exclusion in such instances becomes vague and imprecise (i.e., without guidance, how is an employee supposed to determine and evaluate the motivation for a gift; should it matter if a friendship dates back to pre-employment days or developed through working with each other; should a line be drawn between intimate dating relationships and other types of relationships, etc.?). Some policies broadly exclude, at least from the numerical limits of the policy, gifts and entertainment from both immediate family and friends, but require that any such items be reported nonetheless. While this approach has the advantage of improving the adviser's monitoring capabilities, it may encounter resistance on the part of employees not wishing to share personal information like the value of their Christmas gifts.

The easiest test to administer fully excludes (both from the policy and any reporting requirement) appropriate gifts and entertainment if based on specific, narrow, and enumerated relationships (i.e., spouses and immediate family members) but would not exclude non-enumerated relationships (i.e., friends and extended family). Such a distinction allows for minimal discretion in evaluating the nature of relationships as an employee's immediate family is an objective and verifiable categorization. Further, advisers often separately require that employees report whether their spouses or immediate family members are employed by brokers or vendors (including the nature of such employment), which allows the adviser to monitor potential conflicts of interest arising from these relationships (knowing whether spouses spend a lot on their anniversary presents adds little to the adviser's monitoring goals, but would be highly intrusive to the employee).

Under this approach, gifts and entertainment provided by persons outside of the narrow exclusion (i.e., anyone other than spouses and immediate family) may still be excluded from the policy, but only if properly reported and evaluated. The adviser need not (although it could) require reporting of the value of such gifts and entertainment, as the potential conflicts of interest of concern to the adviser often follow from the nature of the relationship itself and not the actual value of the gift or entertainment (further, requiring valuations may encounter resistance and discourage reporting in the first instance). The absence of a valuation, however, requires that the description in the report contain sufficient detail to permit informed oversight.

Accordingly, to be effective, the policy should specify the factors an employee should note when reporting gifts and entertainment, thus allowing supervisory evaluation of the appropriateness of the gift or entertainment. Potential factors include the nature and duration of the relationship and whether the gift or entertainment was paid for by the giver or his or her employer. The report should also discuss whether the employee and the gift giver are in positions to influence decisions at their organizations and, most importantly, whether the employee and the gift giver are in positions from which they can (or actually do) conduct business together (i.e., an employee's personal relationship with a trader at a broker used by the adviser raises more concerns than a similar personal relationship with an employee of the broker working in a department that the adviser has no contact with). As it relates to the gifts and entertainment policy, if the report indicates a close personal relationship (a gift from a groomsman), no further action under the policy would be required (the relationship would be monitored for other conflicts of interest, however); whereas if the report raises concerns (a gift from a cousin recently employed by a vendor whom the employee may not have seen for years), further inquiry would follow and the gift or entertainment may be restricted. Further, beyond the gifts and entertainment policy, learning of the existence and nature of personal relationships, irrespective of gift giving, allows the adviser to best monitor conflicts arising from the relationship itself, albeit in a potentially imprecise manner (relations that do not exchange gifts would not require reporting). Determining the contours of a friends and family exclusion is difficult, but discussions with affected personnel, as discussed, can be very helpful in determining the extent of potential relationships and how best to address the subject.

Implementation of a Gifts and Entertainment Policy

As noted, it is critical that any gifts and entertainment policy be systematically monitored for compliance and that employees receive training to help them thoroughly understand the contents and import of the policy.
Reporting

Various methods are used to monitor compliance with the policy. The most common form of monitoring involves a reporting requirement. Many policies require reporting of all gifts and entertainment except those that are de minimis or otherwise specifically excluded (see the previous discussion concerning family and friends). Other policies require reporting of all gifts and entertainment (regardless of whether it is below the de minimis threshold set by the adviser), with only special exceptions (i.e., immediate family). While reporting all such gifts and entertainment permits the adviser to best monitor whether limitations contained in the policy have been exceeded, it could burden the adviser administratively and may be subject to frequent underreporting. For example, employees may forget about small gifts or occasional meals. Some policies seek a middle ground by imposing a lower threshold for reporting purposes (for example, individual items over $50), although this approach may unnecessarily confuse employees by substituting two thresholds in lieu of the single, easy-to-remember $100 limit. Depending on the structure and size of the adviser, electronic monitoring may be the only feasible method of administering and monitoring the various reports, in which case specialized computer software may be necessary.

In addition to employee reporting, some advisers seek the cooperation of their brokers and other vendors to monitor compliance with the adviser’s policy. They do this by requesting the vendor to acknowledge in writing that they will seek to assure compliance with the adviser’s gifts and entertainment policy by personnel doing business with the adviser. In some cases, they may ask for periodic reports and expense account items relating to gifts and entertainment provided to employees of the adviser. Cooperation could become even more extensive in the future. For example, NASD member firms are subject to detailed recordkeeping requirements and, under the proposed NASD Gifts and Entertainment Release, detailed records of business entertainment expenses would have to be made available to customers of NASD-member firms. The adviser could use these records to cross-check records submitted by its employees. Should this proposal be adopted for brokerage personnel, some advisors may seek similar assistance from other vendors.

While a reporting requirement should, in and of itself, act to deter some inappropriate conduct, it is critical that the reports actually be monitored. There is little point and, from a regulatory perspective, much danger in requiring detailed reporting of gifts and entertainment if the reports are never reviewed by qualified personnel. Regulators, in connection with a review of an adviser’s gifts and entertainment policy, would be looking to see how the adviser uses reports generated under the policy. Moreover, a reporting requirement provides only evidence of red flags if an issue could have been averted had the reports simply been read.

Pre-Clearance

Many policies, in addition to a reporting element, require pre-clearance for certain categories of gifts and entertainment. For example, advisers may find it useful (depending on the firm culture and the resources available to implement the policy) to require that gifts or business entertainment events exceeding a specified value (or regularity), or of a certain type (i.e., offer of travel expenses or hotel costs) receive pre-clearance from the adviser’s supervisory or compliance personnel or other appropriate person. As with other aspects of the gifts and entertainment policy, advisers generally weigh the costs and benefits of implementing a pre-clearance requirement. In order for the requirement to be workable, certain exclusions may be necessary (i.e., last-minute business entertainment invitations and unexpected gifts). If the policy includes a pre-clearance element, it generally specifies the factors to be considered in granting clearance and the appropriate procedures to follow (including retention of records). It is also important to ensure consistency in the granting of clearances throughout the adviser’s organization, through the training of supervisory personnel or otherwise.

Training

A critically important aspect of an effective gifts and entertainment program is the training program. Often, training is not specifically discussed in the gifts and entertainment policy, but is provided in connection with other aspects of the adviser’s compliance program. Regular training concerning the gifts and entertainment policy is important because some of its substantive provisions may not be intuitive to employees and could directly impact their personal lives. Advisers often find that training is valuable as a means of receiving feedback from employees concerning problems with the implementation of the policy. For example, numerous questions from employees
would suggest a need for greater clarity in specific areas. Further, if the same or related issues are raised by several employees, the adviser can revisit the policy and modify it as appropriate.

Other Implementing Provisions

Implementing provisions concerning the application of the policy should be considered and described as precisely as feasible. For example, reporting requirements often provide precise details of where and when reports should be submitted. Pre-clearance elements frequently specify the process for obtaining necessary clearances. Most policies contain provisions concerning the retention of appropriate documentation (pre-clearance forms, reports, etc.). A documentation requirement, if consistently implemented, encourages more care to be given to the granting of any clearances, which in turn encourages greater compliance with the policy. Some policies outline the range of penalties that may be imposed for violations of the policy. These penalties often range from reprimands (a letter in the employee's file) to dismissal for egregious violations. Policies sometimes explicitly describe how the policy is communicated to employees (as part of an employee handbook, whether a signed acknowledgement is required, etc.).

Finally, some gifts and entertainment policies have explicit provisions that provide for periodic review of the policy and modification as frequently as necessary (even if the policy is not explicit, periodic reviews should be conducted as a matter of good practice). As the SEC staff has recognized in other compliance contexts, compliance is a fluid and dynamic process. It is highly likely that new and unforeseen issues will arise over time. Periodic review allows an adviser to identify elements of the policy that may not be working. Fixing a policy that is not working in some aspect is not necessarily an admission of a failed program, but rather evidence that the adviser is working to address new issues and responding accordingly.

Special Considerations: Application of the Policy to the Giving of Gifts and Entertainment

The discussion so far has focused primarily on limitations and restrictions advisers impose on employees' receipt of gifts and entertainment. Indeed, the adviser's responsibilities to its clients are most susceptible to conflicts of interest when employees are accepting, rather than giving, gifts and entertainment. Nonetheless, to an increasing extent, advisers are addressing their policies to issues involved in the giving of gifts and entertainment. Apart from instances when the giving of gifts and entertainment violate a client's policy or other legal constraints, giving also implicates both business and regulatory hazards, as the adviser would not want to read media reports concerning improper conduct by its employees or impropriety at an adviser-sponsored event. Ideally, policies should limit giving and receiving to the same extent (and some do), but this may unnecessarily inhibit the adviser from marketing and promoting its services in a competitive marketplace.

While restrictions on giving are often different from receiving, a number of reasonable limits are often still imposed. As a threshold, some policies prohibit employees from giving lavish, extravagant, or improper gifts and entertainment. In addition, some advisers prohibit employees from giving gifts or entertainment in contravention of the recipient's employer's policies on gifts and entertainment (if such policies exist). Other provisions, as applicable to the particular adviser, prohibit giving gifts or entertainment that violate regulatory restrictions (i.e., the NASD standards, if applicable to a portion of the adviser's business) or legal restrictions (as noted subsequently, special rules may apply when dealing with government officials in certain jurisdictions or personnel of regulated entities). In many respects, it is easier for advisers to monitor compliance with giving restrictions because employees will often seek reimbursement for such expenditures. Accordingly, advisers are more carefully reviewing expense accounts of employees engaged in marketing activities or other entertainment-prone activities with an eye on the propriety of such expenditures from a recipient's perspective. In some cases, expense account systems are linked to reporting systems under the gifts and entertainment policies.

Apart from business and securities regulatory considerations, gifts and entertainment can involve a risk of criminal investigations or at least serious political scandal. Advisers doing business in foreign countries are regulated by, among other things, the Foreign Corrupt Practices Act, which, broadly speaking, restricts providing gifts to certain government officials. Other laws may apply to state, local, or federal government officials. Similarly, special rules on gifts and entertainment may apply when dealing with pension plans or ERISA-regulated entities. For example, the Department of Labor requires the reporting of aggregate annual gifts over $250 to certain cov-
ered persons associated with union-affiliated pension plans (Taft-Hartley plans). The Municipal Securities Rule Making Board, which regulates the sales of 529 college savings plans, recently amended its rules concerning gifts and other non-cash consideration to more closely follow the approach of the NASD. Although the requirements of these laws and regulations are beyond the scope of this article, when applicable, employees should be made aware that laws or rules in various jurisdictions or under other regulatory regimes may separately prohibit or limit gifts or entertainment. In such instances, employees are frequently trained in the special requirements of applicable regulations and warned that certain conduct, which would be otherwise generally appropriate, may be prohibited simply because of the individual or entity involved.

Conclusion

An effective gifts and entertainment policy appropriately balances the benefits derived from the exchange of business entertainment and gifts with the need of the adviser to monitor and avoid conflicts of interest in fulfilling its fiduciary duties to clients and avoiding regulatory and other law enforcement issues. The elements described need not appear in every adviser’s policy, as every adviser has different needs and risks; however, any provisions that are included are most effective when implemented in a clear and consistent manner so that they are indeed adhered to by employees. In the area of gifts and entertainment, it is important to recognize that the policy can and will affect employees personally and should be structured to account for this dynamic. To this end, it is imperative to receive and incorporate feedback from affected employees for the policy to be successful. This includes an active training program and the flexibility to modify, as necessary, policies that are not working or could be enhanced in certain aspects. If implemented appropriately, in a way tailored to the adviser’s unique organization an adviser will benefit from the strengthening of business relationships through gifts and business entertainment, while at the same time avoiding or minimizing regulatory issues and the actual and potential conflicts of interest inherent in these practices.

NOTES

1. In the release mandating compliance programs for investment advisers and investment companies, the SEC enumerated several issues investment advisers and investment companies would be expected to address, at a minimum, in their compliance programs. The non-exclusive lists encompass broad aspects of the business of advising and operating mutual funds, but do not reference gifts and entertainment policies and procedures. See Rel Nos. IA-2204; IC-26299, Compliance Programs of Investment Companies and Investment Advisers (December 17, 2003). Similarly, Rule 204A-1 under the Investment Advisers Act and Rule 17g-1 under the Investment Company Act, which mandate codes of ethics for certain employees of investment advisers and investment companies, do not impose regulations on gifts and entertainment.


3. NASD Conduct Rule 2830(1) provides, among other things (including a prohibition on the receipt of cash and specified record-retention requirements), that:

   In connection with the sale and distribution of investment company securities:

   (5) No member or person associated with a member shall directly or indirectly accept or make payments or offers of payments of any non-cash compensation, except as provided in this provision. Notwithstanding the provisions of [the Rule], the following non-cash compensation arrangements are permitted:

   (A) Gifts that do not exceed an annual amount per person fixed periodically by the Association [presently $100] and are not preconditioned on achievement of a sales target.

   (B) An occasional meal, a ticket to a sporting event or the theater, or comparable entertainment which is neither so frequent nor so extensive as to raise any question of propriety and is not preconditioned on achievement of a sales target.

   (C) Payment or reimbursement by offerors in connection with meetings held by an offeror or by a member for the purpose of training or education of associated persons of a member, provided that:

   (i) the record keeping requirement [of the Rule] is satisfied;

   (ii) associated persons obtain the member’s prior approval to attend the meeting and attendance by a member’s associated persons is not preconditioned by the member on the achievement of a sales target or any other incentives pursuant to a non-cash compensation arrangement permitted by [the Rule];

   (iii) the location is appropriate to the purpose of the meeting, which shall mean an office of the offeror or the member, or a facility located in the vicinity of such office, or a regional location with respect to regional meetings;

   (iv) the payment or reimbursement is not applied to the expenses of guests of the associated person; and

   (v) the payment or reimbursement by the offeror is not preconditioned by the offeror on the achievement of a sales target or any other non-cash compensation arrangement permitted by [the Rule].

4. See Notice to Members 06-06, NASD Requests Comment on Proposed Interpretive Material IM-3060 Addressing Gifts and Business Entertainment (January 23, 2006) (the NASD
Gifts and Entertainment Notice). NASD Conduct Rule 3060 provides, in pertinent part, that:

(a) 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 where such payment or gratuity is in relation to the business of the employer of the recipient of the payment or gratuity. A gift of any kind is considered a gratuity.

5. Section 17(e) of the Investment Company Act provides:

It shall be unlawful for any affiliated person of a registered investment company, or any affiliated person of such person—

(1) acting as agent, to accept from any source any compensation (other than a regular salary or wages from such registered company) for the purchase or sale of any property to or for such registered company or any controlled company thereof, except in the course of such person's business as an underwriter or broker; or

(2) acting as broker, in connection with the sale of securities to or by such registered company or any controlled company thereof, to receive from any source a commission, fee, or other remuneration for effecting such transaction which exceeds (A) the usual and customary broker's commission if the sale is effected on a securities exchange, or (B) 2 per centum of the sales price if the sale is effected in connection with a secondary distribution of such securities, or (C) 1 per centum of the purchase or sale price of such securities if the sale is otherwise effected unless the Commission shall, by rules and regulations or order in the public interest and consistent with the protection of investors, permit a larger commission.

6. Section 206 of the Investment Advisers Act provides, in pertinent part:

It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud any client or prospective client; (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client; ... (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative.

7. See Section 203(e)(6) of the Investment Advisers Act, allowing for various penalties to be assessed against advisers for, among other things, failing reasonably to supervise, with a view to preventing violations of the federal securities laws, persons under their supervision, unless:

(A) There have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

(B) Such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.


9. The NASD Gifts and Entertainment Notice contains a similar general standard: "when a member interacts with an employee of a customer, the member should not do or give anything of value to the employee that is intended to cause, or otherwise would be reasonably judged to have the likely effect of causing, such employee to act in a manner that is inconsistent with the best interests of the customer."

10. See NASD Conduct Rule 2110 (Standards of Commercial Honor and Principles of Trade).

11. NASD Conduct Rule 2830(f)(4) similarly provides that cash may not be received in connection with the sale and distribution of securities, unless it is described in the current prospectus of the investment company.

12. See also NASD Gifts and Entertainment Notice supra n.4.

13. See ns.3, 4 supra.

14. The NASD, however, proposes including transportation and lodging expenses in its proposed definition of business entertainment. See NASD Gifts and Entertainment Release.

15. See NASD Gifts and Entertainment Release.

16. "Business entertainment" is otherwise defined as "providing entertainment to an employee in the form of any social event, hospitality event, charitable event, sporting event, entertainment event, meal, leisure activity or event of like nature or purpose, as well as any transportation and/or lodging accompanying or related to such activity or event, including such business entertainment offered in connection with an educational event or business conference..." See NASD Gifts and Entertainment Notice supra n.4.

17. See NASD Gifts and Entertainment Notice supra n.4.

18. See NASD Conduct Rule 2830(f)(3) and the NASD Gifts and Entertainment Release.

19. The NASD would impose a similar requirement on member firms. See NASD Gifts and Entertainment Release.


22. See generally, Form LM-10 (Employer Reports) Advisory (November 10, 2005), available at http://www.dol.gov/esa/regs/compliance/olms/1m10_advisory.htm (which contains a link to frequently asked questions concerning the noted reporting form).

23. For a summary of these amendments, see http://www.msrb.org/msrb1/archive/2005/2005-52.asp