

# Gifts, Gratuities and Non-Cash Compensation

DECEMBER 2014

## I. Introduction

### A. Purpose and Structure of Review

FINRA is conducting a retrospective review of its gifts and non-cash compensation rules, and is publishing this report on the assessment phase of the review.<sup>1</sup> The purpose of the review is to assess whether the rules are meeting their intended investor protection objectives by reasonably efficient means and to take steps to maintain or improve the effectiveness of the rules while minimizing negative economic impacts. The review is part of an ongoing initiative launched in April 2014 to periodically look back at significant groups of rules to ensure they remain relevant and appropriately designed to achieve their objectives, particularly in light of industry and market changes.

FINRA has separated the review into an assessment phase and an action phase. During the assessment phase, which is the focus of this report, the staff analyzed the effectiveness and efficiency of the gifts and non-cash compensation rules as currently implemented. The assessment encompassed not only the substance and application of the rules, but also FINRA's processes to administer them.

In the ensuing action phase, FINRA staff intends to consider specific rule proposals or other initiatives resulting from the assessment phase. FINRA will engage in its usual rulemaking process to propose any amendments to the rules based on the assessment.

### B. Assessment Process

The staff followed an extensive, multi-step assessment process. The process afforded stakeholders the opportunity to share their experiences with, and opinions of, the gifts and non-cash compensation rules and included multiple avenues of feedback from the industry. The staff first solicited broad and diverse views through issuance of *Regulatory Notice 14-15* requesting comment on the effectiveness and efficiency of the gifts and non-cash compensation rules. The *Notice* explained the review process and asked the following questions with respect to the rules:

1. Have the rules effectively addressed the problem(s) they were intended to mitigate?
2. What have been experiences with implementation of the rule set, including any ambiguities in the rules or challenges to comply with them?
3. What have been the costs and benefits arising from FINRA's rules? Have the costs and benefits been in line with expectations described in the rulemaking?
4. Can FINRA make the rules more efficient and effective, including FINRA's administrative processes?

FINRA received 11 comments in response to the *Notice*.

In addition, FINRA staff spoke directly with firms and individuals who have direct and substantial experience with the rules. The staff conducted interviews with these subject matter experts (SMEs) representing a cross-section of firm sizes and business models, and diverse viewpoints. The SMEs also included outside counsel knowledgeable about the rules.

During these discussions, FINRA staff invited candid feedback as to which rules are working effectively and efficiently and which are not. The staff expressly sought feedback on the specific provisions or processes that could be improved and endeavored to understand why a rule or provision is not working—for example, lack of clear standards, excessive costs relative to the protection afforded investors, or failure to keep up with technological or market changes. The staff asked the SMEs to identify particular “pain points” in the implementation and administration of the rules and to provide details or examples as to how the rules are impacting their businesses, the markets and investors. The staff also inquired about any regulatory gaps that may exist with the rules, emphasizing that investor protection remains FINRA’s paramount concern.

The staff also sought out the experiences of FINRA’s internal operating departments that work with the rules. The staff integrated the input received from comments to the *Regulatory Notice*, the SME discussions and other consultations and developed a thematic summary of the views expressed. The staff validated the summary with a broader group of stakeholders, including FINRA advisory committees and interested trade organizations.

The thematic summary of the views also informed another critical step in the validation process: the development of a survey that was distributed to all FINRA member firms and non-member firm SMEs. The survey tested the views that emerged during the comment and SME interview process and permitted respondents to identify potentially missing points of view. The survey included general questions about the respondent’s size, business model and degree of engagement with the gifts and non-cash compensation rules to illuminate correlations that could benefit the assessment. The survey also included free text sections to allow respondents to identify issues that may not have been captured by the themes or amplify answers to questions. The survey responses are discussed in detail in Section IV below.

## II. Background and Objectives of the Rules

### A. FINRA Rule 3220

FINRA Rule 3220 (Influencing or Rewarding Employees of Others)<sup>2</sup> (the Gifts Rule) 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.<sup>3</sup> The rule also requires members to keep separate records regarding gifts and gratuities.<sup>4</sup> The rule seeks both to avoid improprieties that may arise when a member firm or its associated persons give anything of value to an employee of a customer or counterparty and to preserve an employee’s duty to act in the best interests of that customer.

In 1999, FINRA staff issued an interpretive letter stating that the Gifts Rule 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.”<sup>5</sup> The 1999 letter noted that the interpretation was based, in part, on FINRA’s rules governing non-cash compensation in connection with the offer and sale of investment company shares and variable annuities.

## B. Non-Cash Compensation Rules

In July 1998, the SEC approved amendments to NASD Rules 2820 (Variable Contracts of an Insurance Company) and 2830 (Investment Company Securities) that imposed new requirements on non-cash compensation arrangements for the sale and distribution of variable contracts and investment company securities. In April 2003, the SEC approved amendments to NASD Rules 2710 (Corporate Financing Rule – Underwriting Terms and Arrangements) and 2810 (Direct Participation Programs) that codified substantially similar requirements on non-cash compensation arrangements in connection with public offerings of debt and equity securities and direct participation programs.<sup>6</sup>

The amendments prohibit a member firm or associated person from directly or indirectly accepting or making payments of any non-cash compensation, subject to specified exceptions.

The exceptions permit:

- ▶ gifts that do not exceed an annual amount per person fixed by the FINRA Board of Governors (currently \$100) and are not preconditioned on achievement of a sales target;
- ▶ 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;
- ▶ payment or reimbursement by “offerors” (product issuers, advisers, underwriters and their affiliates) in connection with training or education meetings, subject to certain conditions, including meeting location restrictions and not preconditioning attendance on achievement of a sales target; and
- ▶ internal firm non-cash compensation arrangements that are based on total production and equal weighting of product sales.<sup>7</sup>

## III. Stakeholder Views

After considering the viewpoints expressed in the comments to *Regulatory Notice 14-15* and during discussions with the SMEs, FINRA advisory committees and trade organizations, as well as the feedback from FINRA’s operating departments, the staff identified the following common themes with respect to the gifts and non-cash compensation rules:

### ▶ General Observations:

- ▶ **Rules Have Been Effective:** Most stakeholders agreed that the gifts and non-cash compensation rules have been effective at addressing the problems they were intended to mitigate, stating that the concerns about bribery and conflicts of interest that existed several years ago are not present today. Stakeholders noted that most firms have created written policies and procedures to implement the requirements of the rules and provide information, training and education to employees regarding the rules’ requirements.
- ▶ **Concerns:** Stakeholders raised concerns that the gifts and non-cash compensation rules are scattered throughout the FINRA rulebook causing difficulties from a reference and compliance standpoint. Some stakeholders also suggested that FINRA consider whether the non-cash compensation rules should be applied consistently to all securities products, rather than just to investment company securities, variable insurance products, direct participation programs and public offerings of securities. In addition, stakeholders requested that FINRA update the existing guidance relating to the rules and address issues not covered by prior guidance.

## ► Gifts:

- **\$100 Gift Limit:** A consistent view expressed by stakeholders was that the \$100 gift limit is too low and that raising the limit would not undermine the purposes of the gifts and non-cash compensation rules. Several stakeholders stated that the \$100 gift limit is particularly restrictive when member firms or their associated persons want to provide gifts to their clients for life events such as weddings, graduations, and the birth or adoption of a child, or as a sympathy or get well gesture. Some stakeholders suggested that any changes to the gift limit should take into account geographical cost differences.
- **Dollar Gift Limit:** Most stakeholders expressed a preference for a FINRA-prescribed dollar limit on gift giving rather than a principles-based approach by which member firms would establish their own gift limits, noting the certainty and simplicity of a FINRA-prescribed dollar limit. A few stakeholders expressed concern that a higher gift limit, or a principles-based approach to gifts, could increase costs to firms and be anti-competitive as it would create an unlevel playing field and put member firms under pressure to provide gifts with a value comparable to those provided by their competitors.
- **Exceptions:** Some stakeholders suggested that even with a dollar gift limit, FINRA should consider a *de minimis* amount below which member firms and their associated persons would not be required to track gifts. Other stakeholders suggested including exceptions from the dollar gift limit for specified life events.
- **Guidance:** Stakeholders suggested a number of areas in which FINRA could provide additional guidance relating to gift giving, such as with respect to charitable contributions, personal versus professional gifts, gifts given to individual retail clients, gifts related to life events, group gifts, gift valuation (*e.g.*, face versus market value), promotional items, raffle prizes and gift cards.
- **Business Entertainment:** Most stakeholders stated that the approach to business entertainment should be principles-based to provide firms with flexibility in setting limits on business entertainment based on the facts and circumstances, including regional cost differences as well as variations in business models. Some stakeholders requested that FINRA provide guidance, including examples, regarding permissible versus impermissible business entertainment.
- **Other Non-Cash Compensation:** Several stakeholders stated that FINRA should apply a principles-based approach to the training or education meetings provisions in the non-cash compensation rules. In addition, a number of stakeholders suggested that FINRA revisit the training or education meeting location restriction to provide more flexibility and that FINRA consider allowing reasonable entertainment as part of training or education meetings.
- **Economic Impact:** Many stakeholders stated that the costs associated with keeping track of gifts, business entertainment and non-cash compensation are burdensome, particularly the \$100 gift limit. Stakeholders indicated that due to the technology, recordkeeping, training and personnel costs associated with ensuring compliance with the rules' requirements, the costs and benefits may not be aligned.

## IV. Survey

### A. Summary of Survey Responses

The survey of member firms and non-member firm SMEs was developed as a method to collect broad feedback on the observations provided through the interview phase of the retrospective rule review process. It served as a method to corroborate or invalidate the primary concerns expressed regarding the gifts and non-cash compensation rules and to identify other possible issues not captured in the SME interviews or by commenters. The survey solicited responses to questions regarding the effectiveness of the current regulatory regime, the priorities for updating the existing rules and the related interpretations and guidance, and the costs and burdens associated with the current rules and potential alternatives.

The member firm survey was sent to all FINRA member firms, approximately 4,200 firms, of which 598 either partially or fully completed the survey. The survey of non-member firm SMEs was sent to 38 SMEs, of which nine completed the survey.

The survey responses mostly confirmed the views expressed during the SME interview and comment process. For example, respondents agreed that the gifts and non-cash compensation rules were effectively addressing the policy concerns that they were designed to mitigate, but the current \$100 gift limit is too low.

While the survey responses were mostly in agreement with the SME and commenter views, there were two issues on which the responses were not aligned. First, SMEs and commenters were generally of the opinion that the costs associated with keeping track of gifts, business entertainment and non-cash compensation are burdensome. According to the survey responses, member firms are largely agnostic about the potential costs associated with the rules.

Second, SMEs and commenters stated that setting the gift limit too high, or applying a principles-based approach to establishing a gift limit, could increase costs to firms. The survey responses did not confirm this concern. Some firms, however, stated that higher limits could potentially create a competitive advantage for large firms, as small firms would not have comparable resources to entertain and provide gifts to clients.

FINRA staff also assessed the degree to which the survey responses differed based on firm size, business activity or experience with the rules. The survey responses indicated only slight differences in the way firms responded to the questions, when the firms were grouped according to these criteria.

The staff's analysis of key themes in the responses is set forth below.

### B. Characteristics of Member Firm Respondents

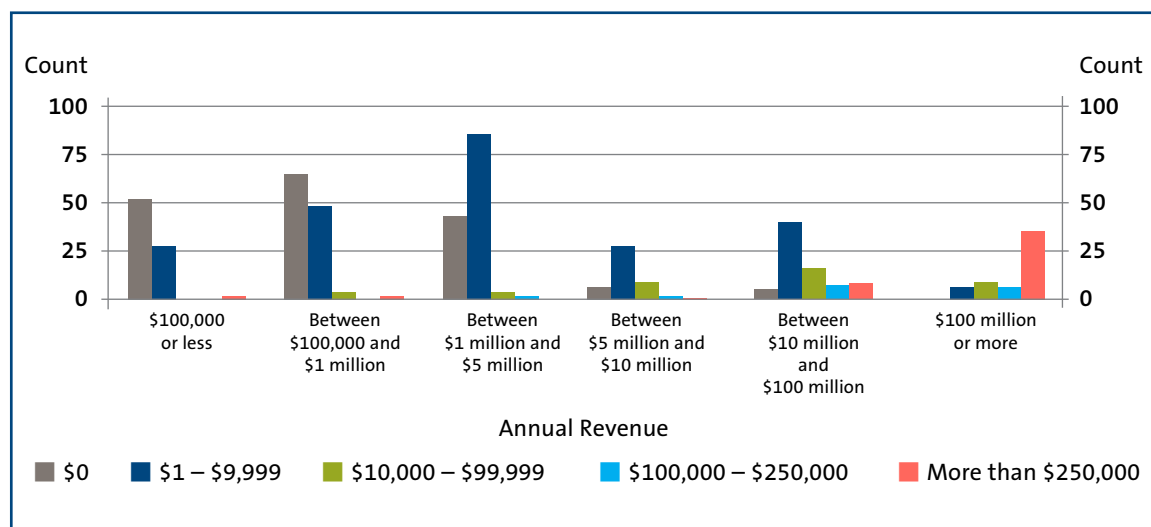
Responding firms typically described their business category as “broker or dealer retailing equity or fixed income securities” and approximately half of the respondents associated themselves with a single business category. More than half of the respondents have institutional customers only. Approximately 84.5 percent of respondents reported to have 150 or fewer registered persons and, therefore, are classified as small firms by the FINRA By-Laws definition.<sup>8</sup> FINRA staff believes that the sample of respondents reasonably represents the FINRA membership.

## C. Analysis of Survey Responses

### 1. Experience With the Rules

Respondents to the survey indicated that they had a range of experience with the rules, as depicted in Figure 1, below.

**Figure 1.** Amount Spent on Gifts, Business Entertainment or Other Non-Cash Compensation in 2013 by Annual Revenue Reported



Member firms responded that their experiences with the gifts and non-cash compensation rules have been mostly positive. A plurality of respondents (48 percent) reported that the gifts and non-cash compensation rules are achieving the policy concerns they were designed to address, while only 14 percent disagreed with that statement.<sup>9</sup>

Approximately the same percentage of respondents as above agreed (47 percent) and disagreed (14 percent) with the statement that FINRA interpretive positions and guidance are clear and helpful. The survey responses also provided evidence in support of SMEs' and commenters' views that the rules protect investors by appropriately limiting the potential conflicts of interest that might arise from gifts, business entertainment and other non-cash compensation.

### 2. Comparative Analysis of Survey Responses

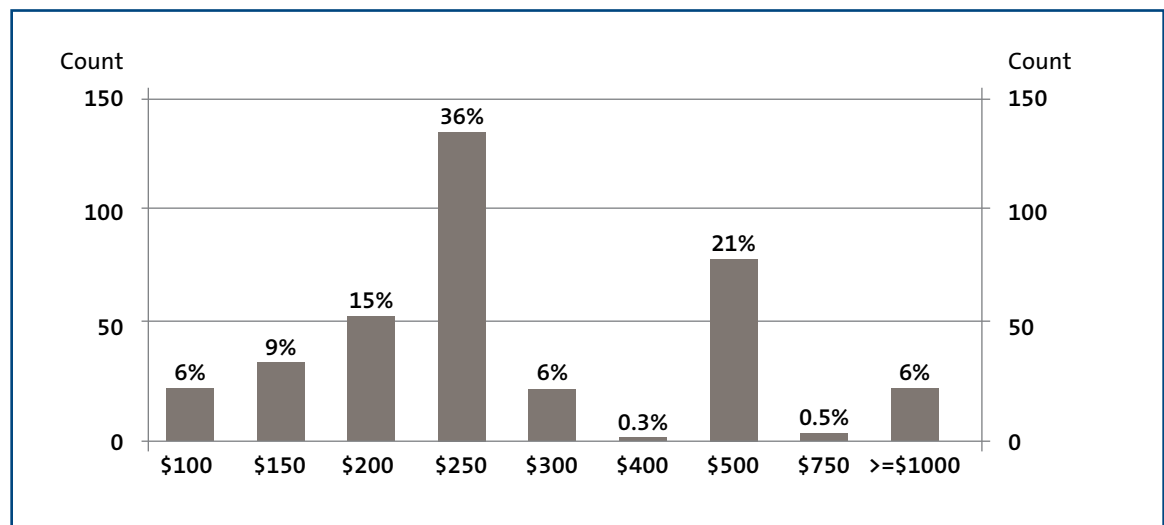
In analyzing the survey responses, the staff also focused on four different sub-group pairs to help identify where different approaches in regulation or interpretation by FINRA might lead to greater efficiency for firms without loss of investor protection. These sub-group pairs differed with respect to the firms' sizes, gift-related activity, types of customers and types of products offered to customers. In the analysis below, the report discusses the four sub-group pairing results where they provide additional context to the analysis.

### 3. Priorities for Updating the Rules and the Related Interpretations and Guidance

Sixty-five percent of the survey respondents supported the idea that FINRA should update the existing rules to provide additional guidance on gifts, business entertainment and other non-cash compensation. Approximately 35 percent of the respondents were neutral about whether FINRA should update the rules in this manner.

The survey results reflected strong agreement among the respondents that the current \$100 gift limit is too low. A small group, approximately 6 percent, reported that the current limit is appropriate. As depicted in Figure 2, approximately 36 percent of the member firms proposed \$250 as an appropriate limit if FINRA were to increase the current limit, whereas 21 percent proposed a \$500 limit. While there was some variation on proposed limits across firms with different sizes, there was no significant relation between firm size and the proposed gift limit. The non-member firm SME respondents to the survey generally proposed a higher limit with an average (median) amount of \$419 (\$400). Similarly, institutional-only firms proposed a higher average (\$370) than retail-only firms (\$321).<sup>10</sup> The median proposed gift limit was \$250 across all four sub-group pairings.

Figure 2. Proposed Gift Limits



Forty-seven percent of the respondents favored a dollar gift limit over a principles-based approach to establishing limits on gifts, whereas only 26 percent favored a principles-based approach over a dollar gift limit. Large firms, specifically, strongly opposed a principles-based approach, whereas the opposition was less pronounced for small firms. A majority of the respondents, 77 percent, supported the suggestion that FINRA should consider a *de minimis* limit below which firms would not have to track gifts.

Firms with institutional clients only, on average, supported geographical differences to the gift limit, while firms with retail clients only were somewhat indifferent. Responses also tended to differ by the type of product sold. Firms that offer mostly fixed income and equity securities supported geographical differences, whereas those that offer mutual funds and variable insurance products slightly opposed geographical differences to the gift limit.

Respondents identified several specific areas where updates to the rules, interpretations and guidance would be most useful. Sixty-eight percent of the respondents identified the need for greater clarity around the applicability of the rules to charitable events or donations. Sixty-five percent of the respondents identified the need for greater clarity regarding the application of the rules to personal versus professional gifts. Fifty-nine percent of the respondents identified gifts related to life events as important for FINRA to address.

Institutional-only firms mostly supported the notion that FINRA should allow firms to establish their own dollar limits on business entertainment. On the other hand, retail-only firms gave mixed responses to this question.

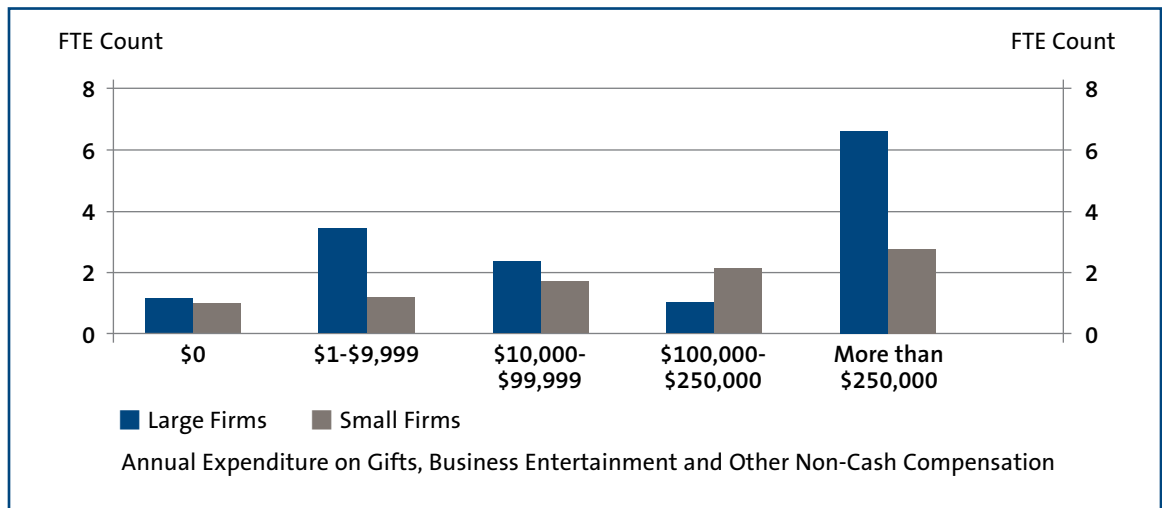
Fifty-six percent of the respondents reported that the rules should permit entertainment for attendees of training or educational meetings. The respondents also supported FINRA providing more flexibility to the firms with respect to training or education meetings. Most respondents agreed that the rules should be applied to all securities products.

#### 4. Costs and Burdens Associated With the Current Rules and Potential Alternatives

In this section of the survey, respondents were asked about current resources used to track gifts, business entertainment and other non-cash compensation, whether the current costs associated with tracking gifts, business entertainment and other non-cash compensation are reasonable, whether the costs outweigh the benefits, and if a principles-based approach would reduce costs.

As might be anticipated, compliance staff tended to increase with the gift, business entertainment and other non-cash compensation dollar activity by the responding firm. For small firms, the range was from an average of one full-time equivalent (FTE) for firms with little or no dollar activity, up to almost three FTEs on average for firms indicating that they have more than \$250,000 in activity. For large firms, the relationship between compliance staff and dollar activity was not monotonic—FTE staffing did not grow uniformly with dollar activity. Large firms reporting between \$1 and \$9,999 have, on average, three and a half FTEs dedicated to compliance.<sup>11</sup> That number decreased with dollar activity until firms reached the highest levels, more than \$250,000 in activity. Firms with more than \$250,000 in activity reported having an average of over six and a half dedicated FTEs.

Figure 3. Average FTE Staff Assigned to Compliance by Size and Dollar Activity



Respondents were largely agnostic about the potential costs of the rules. The total percentage of firms that responded either “Neutral” or “Not Applicable” to the questions in this section varied between 44 percent and 51 percent. Respondents mostly agreed that the costs associated with keeping track of gifts, business entertainment and other non-cash compensation are reasonable. There was no consensus among respondents on the question of whether recordkeeping costs outweigh the benefits, as is also the case for the question on whether a principles-based approach would likely reduce costs to firms.



In addition, respondents indicated that setting the dollar gift limit too high would not likely increase costs to the firms. However, some firms stated that higher limits would provide a competitive advantage to larger firms as smaller firms would not have the same resources available to entertain and provide gifts to clients. Although the survey did not ask directly, several respondents provided comments stating that an industry-wide standard (*i.e.*, “one-size-fits-all” approach) to gifts, business entertainment and other non-cash compensation may have unintended negative consequences, particularly for small firms.

## V. Conclusion

Based on the views expressed, FINRA staff believes that the rules have largely been effective in meeting their intended investor protection objectives. However, the staff believes that the rules and FINRA’s administration of them may benefit from some updating and recalibration to better align the investor protection benefits and the economic impacts.

As set forth above, the assessment identified several areas where opportunities exist to enhance the efficiency of the rules without reducing investor protection. Significantly, many of the identified areas for potential improvement dovetail with the staff’s observations. In addition, the advisory committees, trade organizations and survey results largely validated the views.

In light of the information obtained, the staff recommends exploring a combination of guidance and proposed rule modifications to enhance the effectiveness and efficiency of the rules. The staff recommends initial consideration of the following areas of general agreement among stakeholders:

- ▶ updating the existing guidance and addressing issues not covered by prior *Notices*;
- ▶ consolidating FINRA rules governing gifts and non-cash compensation into a single rule governing both topics;
- ▶ amending the non-cash compensation rules to cover all securities products;
- ▶ increasing the current limits on gifts from \$100 per person per year, including a *de minimis* threshold below which firms would not have to track gifts given or received, and creating exceptions for gifts related to life events;
- ▶ creating a single rule governing business entertainment in all contexts, rather than having multiple rules depending on the products involved; and
- ▶ providing firms and product sponsors with more flexibility regarding the locations of training or education meetings, permitting firms and sponsors to include limited entertainment as part of training or education meetings, and publishing guidance that gives examples of permissible and impermissible training or education meetings.

## Endnotes

1. For purposes of the retrospective review, the rules consist of FINRA Rules 3220, 2310(c), 2320(g)(4) and 5110(h) and NASD Rule 2830(l)(5).
2. In 2008, the Securities and Exchange Commission (SEC) approved the transfer of NASD Rule 3060 into the Consolidated FINRA Rulebook without material change. The rule was renumbered as FINRA Rule 3220.
3. The current \$100 gift limit has been in place since 1992, when the SEC approved an increase in the limit from \$50 to \$100. *See* Securities Exchange Act Release No. 31662 (December 28, 1992), 58 FR 370 (January 5, 1993) (Order Approving File No. SR-NASD-92-40). *See also* Securities Exchange Act Release No. 21074 (June 20, 1984), 49 FR 26330 (June 27, 1984) (Order Approving File No. SR-NASD-84-8) (increasing the gift limit from \$25 to \$50).
4. *See* FINRA Rule 3220(c).
5. *See letter* from R. Clark Hooper, Executive Vice President, NASD, to Henry H. Hopkins, Director, and Sarah McCafferty, Vice President, T. Rowe Price Investment Services, Inc., dated June 10, 1999 (1999 letter).
6. NASD Rules 2710 and 2810 were subsequently renumbered as FINRA Rules 5110 and 2310, respectively.
7. *See* NASD Rule 2830(l)(5) and FINRA Rule 2320(g)(4). FINRA Rules 5110 and 2310 do not require internal firm non-cash compensation arrangements in connection with public offerings of securities or direct participation programs to be based on total production and equal weighting of product sales.
8. Based on FINRA By-Laws, Article I (Definitions), firms with 150 or fewer registered representatives are classified as small, firms with 150-499 representatives are classified as mid-size, and firms with 500 or more representatives are classified as large.
9. “Agree” and “Strongly Agree” results are aggregated throughout the text to indicate the percentage of the respondents that agree with the issues discussed. Similarly, “Strongly Disagree” and “Disagree” responses are aggregated to indicate the percentage of the respondents that disagreed.
10. The difference in the proposed gift limits across the two sub-samples, \$49, is not statistically significant at conventional levels.
11. The survey gave respondents a truncated set of responses to the question of FTE staff assigned to compliance, as can be seen by the distribution of responses in Figure 3. Therefore, the staff estimated the average of FTE staff by assuming 0.5 FTEs for responses “Less than 1,” the mid-point for the next two options, and eight FTEs for “More than 5.” This methodology most likely underestimates the relative FTEs assigned for those firms with the largest compliance staffs.

**Investor protection. Market integrity.**

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