Corporate Department

November 9, 2016

FINRA Proposes Amendments to Its Gifts, Gratuities and Non-Cash Compensation Rules

On August 5, 2016, FINRA published Regulatory Notice 16-29 ("RN 16-29"), which proposes revisions to the regulation of broker-dealer gifts, entertainment and non-cash compensation. The proposal includes amendments to FINRA Rule 3220 (Influencing or Rewarding Employees of Others), and new proposed FINRA Rules 3221 (Restrictions on Non-Cash Compensation) and 3222 (Business Entertainment). The proposal will consolidate the rules and incorporate existing guidance and interpretive letters.

Background

In April 2014, FINRA published a notice seeking comment on the "Effectiveness and Efficiency of its Gifts and Gratuities and Non-Cash Compensation Rules" (FINRA Notice 14-15). This was followed by a survey to all member firms to assess their views of the comments received in response to Notice 14-15 and a review report in December 2014. The latest step is the proposed rules provided in RN 16-29.

Summary of Changes

The proposed rules will:

- increase the limit on gifts from the broker-dealer or its associated persons, in connection with the business of the broker-dealer, from $100 to $175 per person (in the aggregate) per year;
- include a *de minimis* threshold of $50, below which firms would not have to keep records of gifts given or received;
- amend the non-cash compensation rules to cover all securities products. Currently, they apply only to direct participation programs, variable insurance contracts, investment company securities and public offerings of securities;
- set requirements for non-cash compensation in internal sales contests so that if payment or reimbursement of expenses associated with the non-cash compensation is preconditioned on achievement of a sales target, the non-cash compensation arrangement must:
    - be based on the total production with respect to all securities products; and
    - not be based on conditions that would encourage an associated person to recommend particular securities or categories of securities.

The Gifts Rule

Currently, the Gifts Rule prohibits FINRA members and their associated persons from giving anything of value in excess of $100 per year to any person if the payment is connected with the business of the recipient's employer. All gifts by the member firm and its associated persons must be aggregated and records maintained. Under the proposed revisions, the $100 limit would be increased to $175 per recipient, per year in the aggregate. FINRA's basis for the proposed increase is the rate of inflation since the current limit was adopted in 1992. Also to be added to the Gifts Rule is guidance previously found in interpretive material:

- **Gifts incidental to business entertainment**. Gifts given in the course of business entertainment must be part of the $175 per year limit unless it is of *de minimis* value or a promotional or commemorative item (see below).
- **Valuation of gifts**. Gifts must be valued at the higher of cost or "market value," exclusive of tax or delivery charges. Tickets must be valued at the higher of actual cost to the broker-dealer or face value, not necessarily an inflated scalper price. Gifts given to multiple recipients may be pro-rated per recipient.
- **Bereavement Gifts**. Bereavement gifts that are customary and reasonable are not considered to be in relation to the business of the recipient and are not subject to the $175 per year limit or recordkeeping requirements.
- **Personal Gifts**. Gifts given for infrequent life events (e.g., a wedding or the birth or adoption of a child) are not subject to the $175 per year limit or to recordkeeping requirements, provided the gifts are customary and reasonable, personal in nature and not in relation to the business of the employer of the recipient. When the member firm bears the cost of the gift, FINRA presumes that such gift is not personal in nature.
- ***De Minimis* and Promotional Items**. Gifts of a *de minimis* value, promotional items of nominal value and commemorative items are not subject to the restrictions of the Gifts Rule or its recordkeeping requirements provided the value of the gift is less than $50.

Restrictions on Non-Cash Compensation – Rule 3221

Current FINRA rules prohibit members and their associated persons from directly or indirectly accepting or making payments or offers of non-cash compensation in connection with the sale of certain contracts and securities, including variable insurance contracts, investment company securities, direct participation programs and public offerings of debt and equity securities.

Under proposed FINRA Rules 3221 restrictions on non-cash compensation will extend to payments in connection with the sale of any security. Rule 3221 would consolidate current non-cash compensation rules and guidance (including Rules 2310, 2320, 2830 and 5110) into Rule 3221. The prohibitions of Rule 3221 would incorporate existing exceptions, such as:

- Gifts that do not exceed the $175 per person per year threshold and are not preconditioned on the achievement of a sales target;
- Payments or reimbursements of associated persons' expenses in connection with a training or education meeting held by an offeror or a FINRA member, provided that certain conditions are met; and

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- Non-cash compensation arrangements between a member and its associated persons or a non-member company and its sales personnel who are associated persons of an affiliated member if:
  - the compensation is not preconditioned on achievement of a sales target, or
  - the compensation is preconditioned on achievement of a sales target, but the arrangement is:
    - based on the total production of associated persons with respect to all securities distributed by a member, and
    - not based on conditions that would encourage an associated person to recommend particular securities or categories of securities.

Ban on Sales Contests. In addition to consolidating existing non-cash compensation rules, proposed Rule 3221 bans product-specific internal sales contests.

De Minimis Relief. Proposed FINRA Rule 3221 excludes restrictions on gifts of a *de minimis* value, promotional items of nominal value, and commemorative items.

Recordkeeping. The proposed rules require member firms to retain records of all non-cash compensation received *or* given by the member or its associated persons.

Business Entertainment – Proposed Rule 3222

Existing FINRA guidance on business entertainment provides that the Gifts Rule does not prohibit "ordinary and usual business entertainment" provided that the entertainment "is neither so frequent nor so extensive as to raise any question of propriety."

Proposed FINRA Rule 3222 would consolidate FINRA's interpretive guidance regarding business entertainment into a single rule and require each member to adopt written policies and procedures relating to business entertainment tailored to its business needs applying a principles-based approach designed to detect and prevent entertainment that is intended as, or that could reasonably be perceived as, an improper *quid pro quo*.

Under proposed Rule 3222, those policies and procedures must:

- describe permissible and impermissible entertainment based on the location, nature, frequency and dollar amount of the entertainment;
- require employee training;
- require the attendance of an associated person of the firm at the business entertainment and prohibit entertainment preconditioned on achieving a sales target; and
- include detailed recordkeeping. Note that the other two proposed rules have a $50 *de minimis* exemption from recordkeeping and limits, but the business entertainment rule has no such exemption.

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Comment Letters

Sixteen comment letters were received by FINRA and published in response to RN 16-29. Most approved of FINRA's efforts to consolidate the gifts, gratuities and non-cash compensation rules and guidance into one comprehensive rule series.

Among the comments received were suggestions:

- That the gift limit be increased above $175. A few of the comment letters recommended a principles-based approach instead of a new fixed maximum.
- That the *de minimis* threshold for gifts be increased. A few letters raised concerns that enforcing the $50 limit may not provide the anticipated relief.
- Business entertainment recordkeeping requirements are too burdensome.
- That the requirement that gifts be valued at the higher of cost or "market value" was too arbitrary and difficult to determine. Suggested applying the standard proposed for tickets apply to all gifts - higher of cost or face value.

Next Steps

FINRA will likely take several months to consider the comment letters, make any revisions to the proposed rules and then submit them to the SEC. This will then trigger another review and comment period. Rule changes may be finalized by late 2017 and then some period of time allowed for FINRA members to comply with the new rules.

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