

DEVELOPING AND VETTING NEW PRODUCTS

Richard T. Chase
RBC Capital Markets Corporation
One Liberty Plaza, 165 Broadway
New York, NY 10006
Telephone: (212) 858-7111
richard.chase@rbccm.com

Alan J. Herzog
A.G. Edwards & Sons, Inc.
One North Jefferson
St. Louis, MO 63103
Telephone: (314) 955-6559
alan.herzog@agedwards.com

John V. Ayanian
Morgan, Lewis & Bockius LLP
1111 Pennsylvania, Ave., N.W.
Washington, DC 20004
Telephone: (202) 739-5946
jayanian@morganlewis.com

National Society of Compliance Professionals, Inc.
2005 NSCP National Membership Meeting
Alexandria, VA
October 25, 2005

I. INTRODUCTION¹

NASD expressed concern about the number of increasingly complex products introduced to the market “in response to the demand for higher returns or yield.” In the NASD’s opinion, some of these products have unique features that may not be well understood by investors or registered persons, while others raise concerns about suitability and potential conflicts of interest.

In its Notice to Members 05-26 (“NTM 05-26”),² the NASD urged firms to take a proactive approach to reviewing and improving their procedures for developing and vetting new products, stating that at a minimum, those procedures should (a) include clear, specific and practical guidelines for determining what constitutes a new product, (b) ensure that the right questions are asked and answered before a new product is offered for sale, and, (c) when appropriate, provide for post-approval follow-up and review, particularly for products that are complex or are approved only for limited distribution.

NTM 05-26 included guidance on the kind of questions NASD members should be asking before offering a new product, and to highlight a number of best practices employed by some firms that the NASD believes others should consider in reviewing their current procedures.

The NASD has previously issued guidance concerning the due diligence review of hedge funds and non-conventional investments, which is helpful in constructing new product review procedures. Notice to Members 03-07 and 03-71³ present a critical discussion of a broker-dealer’s suitability obligations with respect to the sale of securities products.

In addition, the Securities and Exchange Commission, along with the major financial regulators (collectively, the “Agencies”),⁴ issued a joint statement proposing internal controls and risk management procedures to address reputational, legal and other risks associated with the approval of complex structured finance transactions.

II. CURRENT NASD RULES AND GUIDANCE GOVERNING THE SALE OF SECURITIES PRODUCTS

A. Suitability

1. The NASD’s suitability rule, Conduct Rule 2310, requires that broker-dealers have a “reasonable grounds for believing that the recommendation is suitable for such customer upon the facts, if any, disclosed by the customer regarding his or her other securities holdings, financial situation and needs.”

¹ Copyright © 2005 *Morgan, Lewis & Bockius LLP*. All rights reserved. This outline provides general information on the subject matter discussed and should not be relied upon for legal advice on any matter. The views expressed are those of the panelists and do not necessarily reflect those of their employers, clients or colleagues. This outline has been updated and is current as of August 18, 2005, when submitted to National Society of Compliance Professionals, Inc.

The panelists wish to thank Catherine Courtney of Morgan Lewis & Bockius LLP for her contribution to this outline. Catherine is an associate in Morgan Lewis’ Broker-Dealer practice in the Washington, DC office.

² See Notice to Members 05-26 *NASD Recommends Best Practices for Reviewing New Products* (April 2005) (“NTM 05-26”).

³ See Notice to Members 03-71 *NASD Reminds Members of Obligations When Selling Non-Conventional Investments* (November 2003) (“NTM 03-71”); Notice to Members 03-07 *NASD Reminds Members of Obligations When Selling Hedge Funds* (February 2003) (“NTM 03-07”).

⁴ Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve, Office of Thrift Supervision, Federal Deposit Insurance Company. See SEC Rel. No. 34-49695 *Policy Statement: Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities* (May 13, 2004) (“Interagency Statement”).

2. The Rule also requires broker-dealers to make reasonable efforts to obtain information concerning:
 - a. the customer's financial status;
 - b. the customer's tax status;
 - c. the customer's investment objectives; and
 - d. such other information considered to be reasonable in making a recommendation.

B. Suitability: A Two-Step Process

The NASD further describes a broker-dealer's suitability review as a two-step process:⁵ (a) reasonable basis suitability (due diligence) and (b) customer-specific suitability.

1. Reasonable Basis Suitability (Due Diligence)⁶

The broker-dealer must have a belief that a securities product directly or indirectly recommended is suitable for some investors. The NASD has noted in its recent Notices to Members ("NTM") pertaining to the sale of hedge funds and non-conventional products ("NCI") that broker-dealers must discharge this requirement by conducting due diligence with respect to the product before making any recommendation to a customer.⁷

a. Understanding the Investment Product

A reasonable-basis suitability analysis can only be undertaken when a broker-dealer understands the investment products it sells. Accordingly, a broker-dealer must perform appropriate due diligence to ensure that it understands the nature of the product, as well as the potential risks and rewards associated with the product.

For example, the NASD identified some common features that broker-dealers must understand about NCIs⁸ and hedge funds before registered representatives can perform the appropriate suitability analysis. These features include, but are not limited to:

- (i) the liquidity of the product;
- (ii) the existence of a secondary market and transparency of pricing in any secondary market transactions;
- (iii) the creditworthiness of the issuer;
- (iv) the creditworthiness and value of any underlying collateral;

⁵ See Notice to Members 01-23 *Suitability Rule and Online Communications* (April 2001).

⁶ NASD's use of the term "due diligence" is not intended to equate the responsibilities of a broker-dealer for its sales conduct obligations with the requirements of an underwriter under Section 11 of the Securities Act of 1933 and Securities Act Rule 176. NTM 03-71.

⁷ NTM 03-07 and NTM 03-71.

⁸ The NASD cautioned that the fact that a broker-dealer intends to offer an NCI only to institutional investors does not relieve the broker-dealer of its responsibility to conduct due diligence and a reasonable-basis suitability analysis.

- (v) the creditworthiness of the counterparties;
- (vi) principal, return, and/or interest rate risks and the factors that determine those risks;
- (vii) the tax consequences of the product;
- (viii) the costs and fees to purchase and sell the product;
- (ix) an investigation of the background of the issuer or manager (in the case of a hedge fund);
- (x) a review of the offering documents;
- (xi) a review of the subscription agreements; an examination of references, and
- (xii) an examination the relative performance of the product.

b. Reliance on Offering or Disclosure Documents

The NASD clarified that while a broker-dealer may in good faith rely on representations concerning a securities product contained in a prospectus or disclosure document, reliance on such materials alone may not be sufficient for a broker-dealer to satisfy its due diligence requirements where the content of the prospectus or disclosure document does not provide the broker-dealer with sufficient information to fully evaluate the risk of the product or to educate and train its registered persons for sales purposes.

In such case, the broker-dealer must seek additional information about the product or conclude that the product is not appropriate for sale to the public.

In addition, broker-dealers should ensure that the persons responsible for conducting due diligence have appropriate training and skill to evaluate the terms of the investment as well as the potential risks and benefits.

2. Customer Specific Suitability

To satisfy the requirement of customer-specific suitability, a broker-dealer must determine that its recommendation to invest in a specific security is suitable for that particular investor. It should be noted that bringing a specific product to the attention of a customer may constitute a recommendation.⁹

To ensure that a particular investment is suitable for a specific customer, broker-dealers and their registered persons must examine the suitability

⁹ “In particular, a transaction will be considered to be recommended when the broker-dealer or its associated person brings a specific security to the attention of a customer through any means, including, but not limited to, direct telephone communication, the delivery of promotional material through the mail, or the transmission of electronic materials.” *Notice to Members 96-60* (Sept. 1996).

criteria listed in NASD Conduct Rule 2310, above, in making recommendations to the customer.

NASD cautions broker-dealers against relying too heavily upon a customer's financial status as the basis for recommending securities products. A customer's net worth alone is not necessarily determinative of whether a particular product is suitable for that investor.¹⁰

The NASD also warned that complexity of certain products may present challenges when it comes to a broker-dealer's duty to dispense its suitability obligation; however, the difficulty in meeting such challenges cannot be considered as a mitigating factor in determining whether broker-dealers have met their suitability obligations. Products with particular risks may be suitable for recommendation to only a very narrow band of investors capable of evaluating and being financially able to bear those risks.

C. Written Supervisory Procedures

1. All firms that sell new products should have written supervisory procedures (WSPs)¹¹ reasonably designed to ensure such new products have been thoroughly vetted from a regulatory as well as a business perspective. This requirement applies both to firms that originate and distribute such new products.
2. The WSPs should identify what constitutes a new product, and ensure that the right questions are asked and answered before a new product is offered for sale.
3. Broker-dealers must ensure that their WSPs require that (1) the appropriate due diligence/reasonable-basis suitability is completed before products are offered for sale; (2) associated persons perform appropriate customer-specific suitability analysis; and (3) all relevant NASD and SEC rules are followed.¹²
4. In addition to establishing written procedures, broker-dealers also must document the steps they have taken to ensure adherence to the WSPs and be able to demonstrate adherence to such procedures.

D. Training

Broker-dealers must train associated persons and their supervisors about the characteristics of and risks associated with a particular product before they allow associated persons to recommend the product. The training should focus on the factors that would make such products either suitable or unsuitable for certain investors.

¹⁰ See *Patrick G. Keel*, 51 S.E.C. 282, 286 n.14 (1993) (“[E]vidence of wealth, as we have stated previously, is not an indicator of suitability.”); *Arthur J. Lewis*, 50 S.E.C. 747, 749 (1991) (“The fact that a customer . . . may be wealthy does not provide a basis for recommending risky investments”).

¹¹ NASD Conduct Rule 3010.

¹² This process should be conducted in connection with a broker-dealer's responsibility to test and verify its supervisory policies and procedures as required by the recent supervisory control amendments. See Notice to Members 05-29 Supervisory Controls (April 2005) available at http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_013818.pdf.

Educational pamphlets, videos, intranet systems, web-based systems, in-person lectures, and explanatory memos are all appropriate vehicles for training and may vary based on the type of firm and the firm's size, customer base, and resources.

Broker-dealers may want to consider offering training about complex or novel products as part of the Firm Element of their Continuing Education Program.

III. WHAT IS A NEW PRODUCT?

A. Guidelines Defining a New Product

1. A firm's WSPs should include guidelines for determining:
 - a. what constitutes a new product and
 - b. when a modification of an existing product is material enough to warrant the same level of review as a new product.
2. Guidelines should not assume that if something is "like" a product already in the marketplace, whether offered by the firm or by competitors, that little or no review is necessary.
3. If unsure as to whether something warrants new product review, the best practice is to subject any material modification to an existing product to the same level of review as a new product.
4. The standards for determining what level of review is appropriate for any given product or modification of a product should be clearly communicated and consistently applied throughout the firm.

B. Considerations in Reviewing New Products:

1. Is the product new to the marketplace or the firm?
2. Is the firm proposing to sell a product to retail investors that it has previously only sold to institutional investors?
3. Will the product be offered by representatives who have not previously sold the product?
4. Does the product involve material modifications to an existing product, whether risk to the customer, product structure, possible tax treatment or fees and costs?
5. Does the product require material operational or system changes?
6. Is the product an existing product that is being offered in a new geographic region, in a new currency, to a new type of customer, from a new kind of issuer or in a new form (e.g., unregistered vs. registered)?
7. Would the product involve a new or significant change in sales practices?
8. Does the product raise conflicts that have not previously been identified and addressed?

IV. ASK THE RIGHT QUESTIONS

The NASD outlined in NTM 05-26 the following questions a member should ask and answer before a new product is offered for sale:

1. Is the product proposed for limited or general retail distribution, and, if limited, how will it be controlled? To whom should this product NOT be offered?
2. What is the product's investment objective? How does the product add to or improve the firm's current offerings? Can less costly, complex, or risky products achieve the objectives of the product?
3. What assumptions underlie the product, and how sound are they? What market or performance factors determine the investor's return?
4. What are the risks for investors? If the product was designed mainly to generate yield, does the yield justify the risks to principal?
5. What costs and fees for the investor are associated with this product? Are they appropriate? Are all of the costs and fees transparent? How do they compare with comparable products offered by the firm or by competitors?
6. How will the firm and registered representatives be compensated for offering the product? Will the offering of the product create any conflicts of interest between the customer and any part of the firm or its affiliates? If so, how will those conflicts be addressed?
7. Does the product present any novel legal, tax, market investment, or credit risks?
8. What is the complexity of the product in structure, function, and description? Does such complexity impair understanding and transparency of the product? Does such complexity impact suitability considerations and/or the training requirements associated with the product?
9. How will the product be marketed? Some firms require that sales materials be included in the package provided to the committee that will make the final decision.
10. What are the qualifications of the people making determinations about a new product's assumptions, performance, and risk, and do such qualifications comport with the expertise necessary to reach sound conclusions?
11. Will the product necessitate the development or refinement of in-firm training programs for registered representatives and their supervisors? If so, how and when will the training be provided?
12. Will this product be sold only by the firm, or by third parties? How liquid is the product? Is there a secondary market for the product?
13. Do the firm's current systems support the product, or will new systems be required? If promises will be made to customers (such as volume-based discounts), can current systems deliver on those promises?

14. Does the structure or a feature of the new product, including the proposed sales plan, implicate any additional regulations (i.e., NASD Rule 2860 or NASD Rule 2720)?

V. SURVEY OF BEST PRACTICES

The NASD highlighted in NTM 05-26 the best practices of firms they surveyed:

A. Standardized Process

A mandatory, standardized process that requires a written “new product” proposal and thorough accompanying documentation, that:

1. assigns clear “ownership” of the product or concept to a particular business unit, product group, or department;
2. is clearly communicated to, and has a high profile within, the firm; and
3. is easily accessible to the business units, often through internal Web-based applications that encourage standardization and uniformity.

B. Preliminary Assessment

A preliminary assessment of a proposed product or concept by compliance and/or legal personnel to determine, among other things, whether it is a new product or a material modification of an existing product, and the appropriate level of internal review.

C. Detailed Review

For new products or material modifications to existing products, detailed review by a committee or working group made up of representatives from all relevant sectors of the firm, including compliance, legal, finance, marketing, sales, and operations.

D. Formal Approval or Disapproval

A formal decision to approve, disapprove or table the proposal by a new product committee or other decision-making group that includes members of the firm’s senior management.

E. Post-Approval Follow-up

If the product is approved, some level of post-approval follow-up and review, particularly for products that are complex or are approved only for limited distribution.

VI. INITIAL PRODUCT REVIEW

A. Review and Sign-off

Review and sign-off by every relevant department, before the product is presented to the new products committee for formal approval (or inclusion of representatives of such departments on the committee).

B. Involvement of Legal and Compliance Personnel

Compliance and legal personnel may be attached to specific business units or product groups, so that ideas can be informally discussed with them as the ideas arise or included in the initial product assessment, as well as in the detailed review.

C. Involvement of Operations, Sales and Supervisory Personnel

Such personnel may be in the best position to determine whether current systems support the product, whether additional training is required, and whether offering the product will require any additional licensing for sales personnel.

VII. FORMAL APPROVAL

A. Committee Approval

Formal approval by a committee consisting of representatives from senior management should be required after the appropriate initial review has been completed. According to the NASD, such a practice enhances a firm's ability to apply consistent standards and ensures accountability.

B. Basis for Approval

The committee may base its decision on a written proposal supported by detailed documentation. Such a written proposal may be submitted to the committee in an oral presentation.

C. Formal Approval of Complex Products

Firms should consider whether the approval of complex or unusual products should be made contingent of specific limitations or conditions, including, without limitation:

1. to whom the product can be sold;
2. what kind of training must be required; or
3. what kind of market conditions must exist for the approval to remain effective.

For example, the product may be approved on the condition that it is offered only to customers whose investment objectives are coded "speculative," who have a certain minimum risk tolerance level, or who have a minimum net wealth¹³ or that that no more than a set percentage of a customer's net worth be invested in the same or a similar product.

Broker-dealers should determine prior to approval whether that any conditions or limitations are feasible from a training, supervisory, and operations point of view.

¹³ The NASD cautioned that such limitations do not substitute for a suitability analysis. In addition, as discussed below, in the example given "accredited" status under Regulation D of the Securities Act of 1933 is not necessarily an indicator of sophistication, particularly if the value of the investor's home constitutes a significant percentage of his or her net wealth.

VIII. POST-APPROVAL REVIEW

Broker-dealers should consider establishing a formal post-approval assessment review (e.g., after 6 to 12 months) for (a) complex products, (b) those approved on a contingent basis; (c) those approved on limited basis, or (d) those based on critical market assumptions. According to the NASD, post-approval review allows a firm to assess product performance, determine whether product limitations and other post-sale compliance requirements are met, and to evaluate whether market conditions have altered the risks associated with the product. The NASD suggested that firms ensure that they:

1. track and monitor customer complaints and grievances relating to new products;
2. reassess the firm's training needs regarding a product on a continuing basis;
3. establish procedures to monitor, on an ongoing basis, firm-wide compliance with any terms or conditions that have been placed on the sale of the product;
4. periodically reassess the suitability of the product; and
5. review any product before lifting any restrictions or conditions on the sale of the product.

IX. INTERAGENCY STATEMENT

While the joint statement by the SEC and other Agencies proposing internal controls and risk management procedures for the approval of complex structured finance transactions is instructive, it has never been adopted and, in fact, has faced certain industry objection with respect to the obligation of a firm to understand a client's investment strategy and use of such products for tax purposes.

A. New Product Policies

1. Definition of "New Product"

Firm policies should include a definition of what constitutes a "new" product. In determining whether a product is "new" the following factors should be considered, without limitation:

- a. structural variations from existing products;
- b. whether the product is targeted at a new class of customers;
- c. pricing variations from existing products;
- d. whether the product raises additional or new legal, compliance or regulatory issues; and
- e. Whether the sale of product deviates from standard market practice.

2. Approval Policies

- a. The new product policies should address the roles and responsibilities of all relevant parties including: front office; credit risk; market risk; operations; accounting; legal; compliance; audit; and senior line management.

- b.** The firm's policies should require that new products be approved by all relevant control areas that are independent of the profit center before the product is offered to the public.

3. Reputational and Legal Risk

- a.** The approval procedures should include an evaluation of the impact of the approval of a new product on the firm's reputation.
- b.** The firm's policies should assess the customer's business objectives for entering into a transaction, the economic substance of a transaction, and the appropriateness of a transaction.
- c.** Legal review should include disclosure, regulatory requirements, enforceability of agreements associated with the product, insurance considerations and tax issues.

4. Recordkeeping

Approval documentation should be appropriately detailed and transparent and should be retained and long with any evidence of post-approval monitoring. Such materials may include, without limitation: written analysis or opinions; marketing materials; internal and external correspondence; meeting minutes; and customer disclosures.

REFERENCE MATERIALS

NASD NOTICES TO MEMBERS

05-26 NASD Recommends Best Practices for Reviewing New Products (April 2005) available at http://nasd.complinet.com/file_store/pdf/rulebooks/nasd_0526.pdf.

03-71 NASD Reminds Members of Obligations When Selling Non-Conventional Investments (November 2003) available at http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_003070.pdf.

03-07 NASD Reminds Members of Obligations When Selling Hedge Funds (February 2003) available at http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_003358.pdf.

01-23 Suitability Rule and Online Communications (April 2001) available at http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_003887.pdf.

96-60 *Clarification of Members' Suitability Responsibilities Under NASD Rules With Special Emphasis on Member Activities in Speculative and Low-Priced Securities* (September 1996) available at http://nasd.complinet.com/nasd/display/display.html?rbid=1189&record_id=1159002429.

NASD CONDUCT RULES

Conduct Rule 2310 available at http://nasd.complinet.com/nasd/display/display.html?rbid=1189&record_id=1159000499.

Conduct Rule 3010 available at http://nasd.complinet.com/nasd/display/display.html?rbid=1189&record_id=1159001315.

NASD NEWS RELEASES

NASD Offers Firms Best Practices for Reviewing New Investment Products (April 6, 2005) available at http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_013757.

NASD Reminds Securities Firms of Obligations When Selling Non-Conventional Investments (November 11, 2003) available at http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_002843.

NASD Reminds Members of Obligations When Selling Hedge Funds (January 24, 2003) available at http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_002954.

SEC MATERIALS

SEC. Rel. No. 34-49695 *Policy Statement: Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities* (May 13, 2004) available at <http://www.sec.gov/rules/policy/3449695.htm>.