

DEVELOPING AND VETTING NEW PRODUCTS

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Agenda

- Regulatory Background
 - New Product Suitability
 - Interagency Statement on Complex Structured Transactions
- NASD's New Expectations: NTM 05-29
- What is a New Product?
- Survey of Best Practices
- Written Supervisory Procedures

Regulatory Background

- New Product Suitability
 - NASD 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.”
 - The Rule also requires broker-dealers to make reasonable efforts to obtain information concerning:
 - the customer’s financial status
 - the customer’s tax status
 - the customer’s investment objectives and
 - such other information considered to be reasonable in making a recommendation

Suitability: A Two-Step Process

Reasonable Basis Suitability (Due Diligence)

- 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 NTMs (03-07 (Obligations Selling Hedge Funds), 03-71 (Obligations when Selling Non-Conventional Investments), 05-26 (New Products), and 05-59 (Structured Products)) that broker-dealers must discharge this requirement by conducting due diligence with respect to the product before making any recommendation to a customer.
- In other words, firms must understand the product they are selling.

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.

Interagency Statement On Complex Structured Transactions

- In May 2004, the SEC, Federal Reserve Board, Treasury and other financial regulators issued an "Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities."
- Issued in response to Enron and other accounting scandals, in which it was charged that an array of sophisticated transactions were used to inflate income or hide losses.
- Many of the concepts in the NASD new product guidelines are also included in the statement, but it expands the scope of suitability analysis (e.g., customer's business objectives for doing the transaction; their proposed tax or accounting treatment; whether and how they will publicly report the transaction; and whether senior management of the customer has approved the transaction).
- The proposed statement has not been formally adopted to date.

NASD's New Expectations: NTM 05-26

What is a "New Product"?

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. Is the product new to certain sales representatives?
4. Does the product involve material changes 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?

Survey of Best Practices

- Standardized Process
- Preliminary Assessment
- Detailed Review
- Formal Approval or Disapproval
- Post-Approval Follow-up

Initial Product Review

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).

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.

Initial Product Review (cont'd)

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.

Formal Approval

Committee Approval

Formal approval by a committee consisting of representatives from senior management should be required after the appropriate initial review has been completed.

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.

Formal Approval (cont'd)

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:

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

Post- Approval Review

- Broker-dealers should consider establishing a formal post-approval assessment review (e.g., after 6 to 12 months) for:
 - complex products
 - those approved on a contingent basis
 - those approved on limited basis
 - those based on critical market assumptions

Post- Approval Review (cont'd)

- The NASD suggested that firms:
 - track and monitor customer complaints and grievances relating to new products;
 - continually reassess the firm's training needs regarding a product;
 - 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;
 - periodically reassess the suitability of the product; and
 - review any product before lifting any restrictions or conditions on the sale of the product.

Written Supervisory Policies and Procedures

- All firms that sell new products should have written supervisory procedures (WSPs”).
- 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.
- 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.

Written Supervisory Policies and Procedures (cont'd)

WSPs must require that:

- the appropriate due diligence/reasonable-basis suitability is completed before products are offered for sale
- associated persons perform appropriate customer-specific suitability analysis and
- all relevant NASD and SEC rules are followed