

# Notice to Members

APRIL 2005

## GUIDANCE

### SUGGESTED ROUTING

Internal Audit  
Legal and Compliance  
Retail  
Senior Management

### KEY TOPICS

Best Practices  
New Products  
Non-Conventional Instruments  
Rule 3010  
Suitability

## New Products

### NASD Recommends Best Practices for Reviewing New Products

#### Executive Summary

NASD is concerned about the number of increasingly complex products that are being introduced to the market in response to the demand for higher returns or yield. Some of these products have unique features that may not be well understood by investors or registered persons. Others raise concerns about suitability and potential conflicts of interest. While NASD has and will continue to address specific products as appropriate, NASD also urges firms to take a proactive approach to reviewing and improving their procedures for developing and vetting new products. At a minimum, those procedures should include clear, specific and practical guidelines for determining what constitutes a new product, ensure that the right questions are asked and answered before a new product is offered for sale, and, when appropriate, provide for post-approval follow-up and review, particularly for products that are complex or are approved only for limited distribution.

The purpose of this *Notice* is to remind firms of the kind of questions they should be asking before offering a new product, and to highlight a number of best practices employed by some firms that NASD believes others should consider in reviewing their current procedures.

#### Questions/Further Information

Questions concerning these new reporting provisions can be directed to Eric Moss, Vice President and Director of Emerging Regulatory Issues, at (202) 728-8982; or Laura Gansler, Associate General Counsel, at (202) 728-8275.

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## Background and Discussion

In the current investment environment, investors and brokers are increasingly turning to alternatives to conventional equity and fixed-income investments in search of higher returns or yields. Such products, including asset-backed securities, distressed debt, structured notes, and derivative products, are often complex or have unique features that may not be fully understood by the retail customers to whom they are frequently offered, or even by the brokers who recommend them. Some appear to offer benefits to investors that are already available in the market in the form of less risky, less complicated, or less costly products, prompting concerns about suitability and potential conflicts of interest.

In 2003, NASD published *Notices to Members (NTMs)* addressing the sale of hedge funds and non-conventional instruments to retail customers.<sup>1</sup> More recently, we have proposed new rules tailored specifically to sales of deferred variable annuities, including new sales practice standards, supervisory approval and sales force training requirements,<sup>2</sup> and a new rule establishing pre-use advertising filing requirements for certain products not previously offered by the selling firm.<sup>3</sup> And, as discussed more fully below, we met with numerous firms during the past year to learn more about their practices for developing and vetting new products.

NASD continues to monitor new products carefully and will respond to specific products and problem areas as appropriate. However, we also urge firms to take a proactive approach to reviewing and improving their procedures for developing and vetting new products from a regulatory perspective. While suitability requirements and other sales practice obligations attach to the recommendation and sale of a product, adequate procedures for reviewing new products before they are offered to the public can greatly enhance a firm's ability to detect and avoid conflicts, unsuitable recommendations, and other problems before violations occur.

## Written Procedures for Vetting New Products

As part of the supervisory responsibilities imposed by NASD Rule 3010, all firms that sell new products should have formal written procedures to ensure that no new product is introduced to the marketplace before it has been thoroughly vetted from a regulatory as well as a business perspective. At a minimum, those procedures 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.

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## What Is a New Product?

As a threshold matter, a firm's written procedures should include clear, specific, and practical guidelines for determining what constitutes a new product, including when a modification of an existing product is material enough to warrant the same level of review as a new product. Among the things to consider are:

- ▶ Is the product new to the marketplace or the firm?
- ▶ Is the firm proposing to sell a product to retail investors that it has previously only sold to institutional investors? Will the product be offered by representatives who have not previously sold the product?
- ▶ Does the product involve material modifications to an existing product, whether risk to the customer, product structure, or fees and costs?
- ▶ Does the product require material operational or system changes?
- ▶ Is the product an existing product that is being offered in a new geographic region, in a new currency, or to a new type of customer?
- ▶ Would the product involve a new or significant change in sales practices?
- ▶ Does the product raise conflicts that have not previously been identified and addressed?

This list is not necessarily exhaustive of all factors that determine whether a product is new. Firms should not simply 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. NASD believes that when firms are unsure as to whether something warrants new product review, the best practice is to err on the side of caution, and subject any material modification to an existing product (whether the existing product is sold by the firm or not) to the same level of review as a new product. It is also important that the standards for determining what level of review is appropriate for any given product or modification of a product are clearly communicated and applied throughout the firm in a consistent manner.

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## Ask the Right Questions

The fundamental goal of every vetting process should be to ensure that the right questions are asked during the review period. Consequently, a firm's policies and procedures addressing new products should be designed to answer these questions. While the right questions will depend in part on the nature of the product, NASD believes that, at a minimum, every firm should ask and answer the following questions before a new product is offered for sale:

- ▶ For whom is this product intended? Is the product proposed for limited or general retail distribution, and, if limited, how will it be controlled? Conversely, to whom should this product NOT be offered?
- ▶ 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?
- ▶ What assumptions underlie the product, and how sound are they? What market or performance factors determine the investor's return?
- ▶ What are the risks for investors? If the product was designed mainly to generate yield, does the yield justify the risks to principal?
- ▶ What costs and fees for the investor are associated with this product? Why 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?
- ▶ 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? For example, does the firm stand to benefit from the sale of the product beyond the clearly disclosed sales charges or commissions (*i.e.*, revenue sharing arrangements)? If so, the firm may have an obligation under NASD Rule 2110, governing just and equitable principles of trade, to disclose that conflict, even if the product is otherwise suitable, generally or for a particular investor.
- ▶ Does the product present any novel legal, tax, market investment, or credit risks?
- ▶ 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?
- ▶ How will the product be marketed? What promotional and sales materials will be used? What risks must be disclosed, and how will that disclosure be made? Some firms require that sales materials be included in the package provided to the committee that will make the final decision.

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- 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?
  - 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?
  - 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?
  - 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?
  - 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)?

Asking the right questions is critical not only to determine if the product should be offered at all (is it suitable for targeted investors, does it present insurmountable conflicts between the firm and its customers), but also to identify important features of the product that should be highlighted for the sales and marketing staff, and to plan for appropriate training and supervision.

### **Survey of Best Practices**

To help firms determine whether their current procedures for vetting new products are appropriate, NASD has surveyed a number of firms that manufacture proprietary products and/or distribute third-party products and has conferred with certain of its committees, including the NASD Consultative Committees. The remainder of this *Notice* highlights practices employed by some firms that NASD believes others should consider. These practices can make it easier for firms to comply with their various suitability obligations, avoid conflicts, and plan for appropriate training and supervision. This *Notice* is not intended to be a comprehensive roadmap for compliance and supervision with respect to vetting new products, but rather highlights measures that some firms are using to ensure better compliance. Firms should consider the information in this section of the *Notice* in assessing their own procedures and in implementing improvements that are tailored to and work best for their firm. We note that while a particular sound practice may work well for a large firm, the same approach may not be effective or economically feasible for a smaller firm. While firms must adopt procedures and controls that are effective given their size, structure, and operations, a firm may not fail to have policies and procedures concerning new products reasonably designed to achieve compliance with NASD rules and the federal securities laws because of the limitation of its size, structure, or operations. Using the information in this *Notice* may be helpful, but it is not designed as a safe harbor as circumstances may dictate different practices, processes, and procedures.

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While the procedures used by the firms we surveyed vary slightly depending on their own business model and culture, they tended to share the following components:

- ▶ A mandatory, standardized process that requires a written “new product” proposal and thorough accompanying documentation, that:
  - assigns clear “ownership” of the product or concept to a particular business unit, product group, or department;
  - is clearly communicated to, and has a high profile within, the firm; and
  - is easily accessible to the business units, often through internal Web-based applications that encourage standardization and uniformity;
- ▶ 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;
- ▶ 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;
- ▶ 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; and
- ▶ 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.

## Initial Product Review

Whatever the specifics of a firm’s review process, the most successful processes require review and sign-off by every relevant department, before the product is presented to the new products committee for formal approval.

A number of firms stressed the importance of involving legal and compliance personnel at the earliest possible stage. Some firms do this by having compliance and legal personnel attached to specific business units or product groups, so that ideas can be informally discussed with them as the ideas arise. Others include compliance and legal personnel in the initial product assessment, as well as in the detailed review. However it is done, firms that include these perspectives early in the development process report that their business units are likely to view compliance personnel as a positive “part of the team,” rather than as a stumbling block. The opposite can also be true. When compliance is involved only at the end of the process, there may be less time or inclination to modify the product to address compliance concerns, and the sponsors of the product may have a more adversarial relationship with the compliance and legal teams.<sup>4</sup>

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The firms we surveyed also reported that it is extremely helpful to have operations, sales, and supervisory personnel participate in the product review process, rather than waiting until after a product has been approved to determine what training, controls, or operational enhancements are necessary. Many important questions are best answered by those personnel. For example, they may be in the best position to determine whether current systems support the product, including delivering on promises such as volume-based discounts. If additional training is required, firms should plan in advance how that training will be administered, and how the firm will ensure that only brokers who have had the required training are allowed to offer the product to customers. Firms also should plan to ensure that the necessary training is available as long as the product is offered. Consideration also should be given to whether offering the product will require any additional licensing for sales personnel.

Firms manage the initial review process differently, with many utilizing Web-based applications to streamline and document the process. While some firms rely on the proposing business unit to shepherd a product through the process, at least one firm has established an independent new products group that is responsible for managing the process and ensuring that all relevant departments have reviewed and signed off on the proposed product before it is submitted for formal approval. The new products group also formally notifies all relevant departments about product modifications that it deems do not warrant full review in a process of negative consent; if any department disagrees with the new product group's initial assessment, the product is submitted for full review.

### Formal Approval

After the appropriate initial review has been completed, most of the firms we surveyed require formal approval by a committee consisting of representatives from senior management before a product can be offered, which enhances a firm's ability to apply consistent standards and ensures accountability. The committee may base its decision on a written proposal supported by detailed documentation, an oral presentation, or, as in most cases, both. A number of firms reported that approval of complex or unusual products will often be made contingent of specific limitations or conditions, including 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. 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 wealth. (While these limitations may be helpful, NASD cautions that there is no substitute for a suitability analysis, and "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.) Other conditions of approval might include that no more than a set percentage of a customer's net worth be invested in the same or a similar product. In such cases, it is important to determine prior to approval whether that any conditions or limitations are feasible from a training, supervisory, and operations point of view.

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## Post-Approval Review

Some firms require that complex products, those approved on a contingent or limited basis, or those based on critical market assumptions, be formally reviewed for a specific period of time, often six months or a year. This allows the 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. Firms also should ensure that they:

- ▶ track and monitor customer complaints and grievances relating to new products;
- ▶ reassess the firm's training needs regarding a product on a continuing basis;
- ▶ 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.

## Conclusion

NASD urges firms to take a proactive approach to reviewing and improving their procedures for developing and vetting new products from a regulatory perspective. At a minimum, firms should have in place written procedures for determining what is a new product, and for making sure that the right questions are asked and answered before a new product is offered for sale. In addition, while NASD recognizes that what specific procedures are appropriate will vary depending on firm size and structure, we believe that the best practices identified above can help firms avoid conflicts, unsuitable recommendations, and other problems before violations occur. Finally, NASD notes that even the most elaborate procedures will not be effective unless they are rigorously implemented, something that ultimately depends on the firm's culture and the level of commitment on the part of the firm's leadership.

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## Endnotes

- 1 NASD Reminds Members of Obligations When Selling Hedge Funds, *NTM 03-07* (February 2003), and Non-Conventional Investments, *NTM 03-71* (November 2003).
- 2 Proposed New Rule 2821 Regarding Transactions in Deferred Variable Annuities, SR-NASD-2004-183 (December 2004).
- 3 See *NTM 05-25* (April 2005) (NASD Requests Comment on Proposal to Require Pre-Use Filing of Advertisements and Sales Literature for New Types of Securities and of Television, Video and Radio Advertisements; Comment Period Expires May 20, 2005).
- 4 Nothing in this *Notice* is intended to imply that consultation with legal and compliance personnel in itself alters or shifts supervisory responsibilities within the firm.

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