FINANCIAL REGULATORY QUICK START GUIDE

MIFID II – PRODUCT GOVERNANCE

MiFID II introduced a new and comprehensive product governance regime, representing a fundamental change in the way firms design and distribute financial instruments.

CONTEXT

The MiFID II product governance regime largely replicates a UK domestic regime applicable to manufacturers of retail products.

However, it also expands the regime significantly, applying it to manufacturers and distributors of all MiFID financial instruments (for example, shares, bonds, structured deposits, funds) distributed to both retail and professional investors.

The regime has been introduced to increase investor protection, and ensure that firms think carefully about the products they are selling to clients, not only at the point of sale, but also throughout the product lifecycle.

The key objective is to ensure that firms act in clients' best interests at all times.

MANUFACTURERS

Under the product governance regime, a manufacturer includes an investment firm that creates, develops, issues or designs an investment product.

The key obligations for manufacturers include:

- Identifying the potential 'target market' for each financial instrument
- Determining the appropriate distribution strategy for each financial instrument
- Undertaking scenario analysis, to assess the risks of poor outcomes for clients and the circumstances in which those outcomes may occur
- Making certain information available to any distributor, including:
  - all appropriate information on the financial instrument and product approval process
  - the identified target market, including information about the target market assessment undertaken
  - information about appropriate distribution channels
- Regularly reviewing all of the financial instruments it manufactures
- Obtaining management information from distributors to facilitate product reviews
- Taking action where a crucial event affecting the potential risk or return expectation of the financial instrument occurs

When a MiFID investment firm collaborates with other parties to manufacture a financial instrument, they are treated as co-manufacturers and must outline their mutual responsibilities in a written agreement.

This is the case even if the other party is not a MiFID investment firm or is based outside the EEA.

DISTRIBUTORS

Distributors include investment firms that offer or recommend investment products and services (including on an execution-only basis).

The key obligations for distributors include:

- Having appropriate arrangements in place to obtain and understand relevant information about the product approval process, including the identified target market, distribution strategy, and characteristics of the product
- Using the manufacturer's information and existing information on clients to identify its own target market and distribution strategy (separate from any suitability or appropriateness assessment)
- Reporting certain product information back to the manufacturer including, for example:
  - number of sales made outside the target market
  - summary of complaints received
  - summary information on types of client
- Responding to market events and taking appropriate action, such as reconsidering distribution methods
- Ensuring staff are trained appropriately to understand the product governance requirements
- Ensuring information about products distributed is included in compliance reports to the board

It is the final distributor in the chain who must ensure the product governance obligations have been complied with. Intermediate firms in the chain must enable compliance.

PROPORTIONALITY

Guidance states that the product governance regime may be applied proportionately. This is an important principle, due to the broad application of the rules across both retail and wholesale markets.

However, the guidance does not specify what precisely proportionality means, and so firms have to define for themselves what their obligations ought to be in any given scenario.

Proportionality does not mean that all of the rules may be disapplied. Rather it means that there is some flexibility in the manner in which firms may meet their obligations.

Therefore, firms operating in wholesale markets only for example may be able to implement lighter-touch procedures than firms seeking to sell complex products to retail investors.

EXTRATERRITORIAL IMPACT

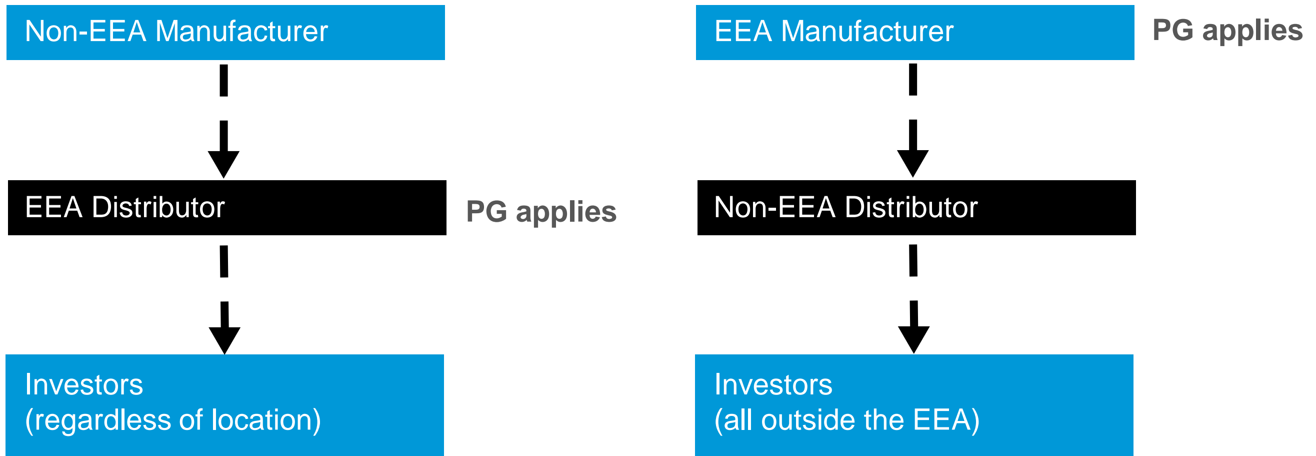
Although the MiFID II product governance regime does not apply explicitly to manufacturers and distributors that are not MiFID investment firms, in practice EEA firms must make certain requests of third country firms involved with the product creation or distribution processes. This is to ensure that the MiFID investment firm is able to meet its own obligations.

The regime will bite whenever there is an EEA investment firm in the chain, even if all other parties in the chain are non-EEA firms, and the end investors are all outside of the EEA (see example scenarios below).

For example, the rules require distributors to obtain certain information from the product manufacturer. MiFID II places no obligation on a third country manufacturer to provide this information to the EEA distributor. Therefore, the distributor is likely to put in place contractual arrangements with the third country firm, to enable the distributor to obtain all of the information it requires.

Similarly, an EEA manufacturer must put in place arrangements with third country distributors, to limit distribution to the defined target market, and require the distributor to pass the required information back up the chain to the manufacturer.

PRODUCT GOVERNANCE – EXTRATERRITORIALITY SCENARIOS



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