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 replicated a UK domestic regime applicable to manufacturers of retail products, but with a significantly increased scope. The requirements apply to manufacturers and distributors of all MiFID financial instruments (for example, shares, bonds, structured deposits, funds) distributed to both retail and professional investors.

Post-Brexit both the EU and the UK continue to apply their own separate versions of the MiFID II product governance regime. The EU regime has an EU-only scope and so applies to EU MiFID investment firms. The UK regime applies to UK MiFID investment firms.

For now these parallel regimes largely remain aligned, but will diverge over time. For example, the EU is removing products marketed or distributed exclusively to eligible counterparties and simple corporate bonds from the scope of its regime.

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 UK/EU.

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.

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.

For example, firms serving only professional clients might take a lighter-touch approach.

EXTRATERRITORIAL IMPACT

The UK/EU MiFID II product governance regimes do not apply explicitly to manufacturers and distributors that are not UK/EU MiFID investment firms. However, in practice firms within scope of these regimes must make certain requests of third country firms (i.e, firms based outside of the UK/EU) involved with the product creation or distribution processes. This is to ensure that the UK/EU MiFID investment firm is able to meet its own obligations.

The regime will bite whenever there is a UK/EU investment firm in the chain, even if all other parties in the chain are non-UK/EU firms, and the end investors are all outside of the UK/EU (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 UK/EU 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 UK/EU 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

Non-EU Manufacturer

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EU Distributor — **EU MiFID PG applies**

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Investors (regardless of location)

UK Manufacturer — **UK MiFID PG applies**

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Non-UK Distributor

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Investors (all outside the UK)

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