MiFID II

Product governance

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MiFID II planning and implementation is a top priority for asset managers affected by European regulations and brings with it both challenges and opportunities.

The new product governance requirements apply to investment firms which create, develop, issue and/or design financial instruments and to investment firms which distribute financial instruments, structured products and investment services, including individual portfolio management, to clients.

Investment firms should be reviewing products they currently manufacture/distribute/recommend, including assessing their respective target markets and client types.

On 13 May 2014, the Council of the European Union formally endorsed a new regulatory regime that will replace the current Markets in Financial Instruments Directive 2004/39/EC (MiFID). The new legislation, in the form of a recast Directive 2014/65/EU (MiFID II) and Regulation 2014/600/EU, is scheduled to be implemented into UK law on 3 January 2018.

Articles 16(3) and 24(2) MiFID II set out specific product governance requirements for investment firms which manufacture financial instruments or offer or recommend financial instruments or investment services to clients. The aim of the product governance rules is to enhance investor protection by ensuring manufacturers and distributors of financial instruments and structured products act in clients' best interests during all stages of the life cycle of the products or services.

Who do the new product governance rules apply to?

The new product governance requirements apply to investment firms which create, develop, issue and/or design financial instruments and to investment firms which distribute financial instruments, structured products and investment services, including individual portfolio management, to clients. An investment firm involved in both the manufacture and distribution of the relevant financial instruments will need to apply both sets of requirements.

AIFMs and UCITS management companies, which are otherwise outside the scope of these rules, will be affected by virtue of the requirements attaching to distributors. This is also true for investment firms that collaborate (including entities not subject to MiFID II) in manufacturing financial instruments which are now required to outline their product governance responsibilities in a written agreement and third country

2007	2011	2014-2015	2016	3 July 2017	3 January 2018
MiFID in force	Proposal for MiFID II	ESMA consults on implementation	MiFID II application delay confirmed	Deadline for incorporation of MiFID II into EU Member State national law	**MiFID II and MiFIR apply**

investment firms marketing financial instruments through an EEA MiFID investment firm. In addition, the FCA's PROD sourcebook applies these rules as non-binding guidance to UK AIFMs and UCITS management companies.

Product governance requirements for manufacturers under MiFID II

Manufacturers of financial instruments must maintain, operate and review a product approval process of each financial instrument before it is marketed or distributed to clients and ensure that staff manufacturing possess the necessary expertise to understand the characteristics and risks of the financial instruments.

The product approval process must identify a target client market, assess relevant risks to that target market and develop a distribution strategy which is consistent with that target market. The rules apply regardless of client type, although the approach to compliance may be appropriate and proportionate, taking into account the target market for the product as well as the nature of the financial instrument or investment service.

Target market

When identifying the potential target market for a financial instrument, manufacturers must, at a sufficiently granular level, specify the types of client for whose needs, characteristics and objectives the financial instrument is compatible as well as identifying one or more groups of client for whose needs the financial instrument is not compatible. ESMA's guidelines on MiFID II product governance requirements provide that the identification of the target market needs to be based on sufficient qualitative considerations as well as quantitative criteria and manufacturers should consider at least the following five categories when identifying the target market:

- The type of target client (retail client/professional client/eligible counterparty).
- The knowledge and experience target clients should have.
- The financial situation of the target clients and their ability to bear losses.
- The general attitude of target clients to risk.
- The objectives and needs of target clients.

As manufacturers may not have direct contact with end clients, their assessment of needs and characteristics of target clients may be based on their theoretical knowledge and experience of the financial instrument.

Distribution strategy

Manufacturers are required to ensure their distribution strategy is consistent with the identified target market and to take reasonable steps to ensure the financial instrument is distributed to the identified target market. To achieve this, the ESMA guidelines propose that manufacturers define the distribution strategy so it favours the sale of a particular product to the relevant target market and that they use their best efforts to select distributors whose type of clients and services they offer are compatible with the target market of the particular product.

Information for distributors

Manufacturers must make available to their distributors all appropriate information on the financial instrument, the product approval process (including the identified target market) and information on the appropriate investment service through which target clients should acquire the relevant financial instrument in order to enable distributors to understand and distribute the financial instruments properly.

Regular review

Manufacturers must review the financial instruments offered or marketed to assess whether they remain consistent with the needs of that market and whether the distribution strategy remains appropriate. The regularity of review will depend on factors such as the complexity or innovative nature of the financial instrument. In order to support the manufacturer's product review, distributors will be required to provide information on sales (including sales made outside the target market or distribution strategy) and post-sales reviews.

Conflicts of interest

Manufacturers must put procedures in place to ensure that the manufacture of financial instruments complies with the requirements on proper management of conflicts of interest, including remuneration. Manufacturers must analyse potential conflicts of interest each time a financial instrument is manufactured and ensure the design of financial instruments does not adversely affect end clients or lead to problems with market integrity.

Product testing

Manufacturers must undertake product testing to assess the risk of, and the circumstances in which there may be, poor outcomes for end clients posed by the financial instrument and to assess their financial instruments under negative conditions, such as in a deteriorating market.

Charging structure

Manufactures will be required to consider whether the charging structure proposed for the financial instrument is clear to target investors, whether the charges will undermine the products return expectations and if they are compatible with the needs, objectives and characteristics of the target market.

Product governance requirements for distributors under MiFID II

Under the MiFID II product governance requirements, distributors are required to understand the financial instruments they distribute to clients, to assess the compatibility of the financial instruments with the needs of the clients to which they distribute (taking into account the manufacturer's identified target market of end clients) and to ensure that financial instruments are distributed only when this is in the best interests of the client.

Target market

Distributors need to develop their own target market for the financial instruments and undertake their own assessment of the target market, in an appropriate and proportionate manner, using information from the manufacturer and information and knowledge of their own client base. This requirement is independent of and in addition to the requirement to carry out a suitability or appropriateness assessment when providing investment services to a client.

Distributors should consider the same categories (in the ESMA guidelines) as manufacturers when identifying the target market taking into consideration the nature of the financial instrument and how this fits with an end clients' needs and risk profile, the impact of charges, the financial strength of the manufacturer and how efficiently and reliably the manufacturer will deal with the end client. ESMA's guidelines provide that distributors should define their actual target market on a more 'concrete level' that a manufacturer and should conduct this assessment as part of its general decision making process about the range of services and products it will distribute.

ESMA's guidelines provide that, when providing investment advice adopting a portfolio approach and portfolio management to a client, a distributor can use products for diversification and hedging purposes and can sell products outside the product target market if the portfolio as a whole or the combination of a financial instrument with its hedge is suitable for the client.

Where a firm is acting as both the manufacturer and distributor of the product, only one target market assessment is required.

Distribution strategy

Distributors must define their own distribution strategy based on their clients and the types of investment services that they provide.

Information from the manufacturer

Distributors must obtain information from the manufacturer to gain the necessary understanding and knowledge of the financial instruments they intend to distribute in order to ensure the financial instruments are distributed in accordance with the needs, characteristics and objectives of the target market. A distributor that offers or recommends financial instruments that it does not manufacture must have in place adequate arrangements to obtain information on the product and approval process, and to understand the characteristics and target market of each financial instrument (as well as any services marketed).

Distributors of financial instruments manufactured by a non-MiFID firm must take all reasonable steps to comply with these requirements and put in place effective arrangements to ensure they obtain sufficient, adequate and reliable information from the manufacturer.

Distributors which distribute financial instruments to other distributors must ensure that relevant product information is passed from the manufacturer to the final distributor in the chain and enable the manufacturer to obtain information on product sales from the end distributor.

Regular review

Distributors must regularly review the financial instruments they distribute and the investment services they provide taking into account any event that could materially affect the potential risk to the identified target market. Distributors must at least assess whether the financial instrument or investment service remains consistent with the needs, characteristics and objectives of the target market and whether the distribution strategy continues to be appropriate. Where it identifies that the target market is wrong or the financial instrument or investment service does not meet the circumstances of the target market it must take appropriate steps, such as reconsidering the target market.

Next steps for investment firms

Investment firms should be reviewing products they currently manufacture/distribute/recommend, including assessing their respective target markets and client types. Where third party distributors are engaged, distribution agreements and any sub-distribution agreements should include obligations on distributors to provide sales information in order to allow product manufacturers to review their products and on product manufacturers to provide product information to distributors. Firms that collaborate in product manufacturing should consider what agreements they will need to implement.

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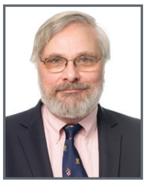

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