MiFID II – Product governance procedures

Overview

Directive 2014/65/EU on markets in financial instruments (**MiFID II Directive**), the Commission Delegated Directive EU (**MiFID II Delegated Directive**) and the Markets in Financial Instruments Regulation (**MiFIR**) (referred to herein to as **MiFID II**) introduces new EU-wide rules governing investment firms, trading venues and market structures, as well as third-country firms providing investment services or activities in the EU.

This memorandum focuses on product governance obligations for firms which either (a) manufacture or (b) distribute financial instruments and the requirements for alternative investment fund managers and UCITS management companies (collectively referred to herein as **ManCos**) in the process.

The product governance obligations under MiFID II will not apply directly to ManCos when carrying out the activity of managing or marketing a fund for which they are ManCo, but will apply to a MiFID firm that is marketing or distributing a fund on behalf of a ManCo. As a result, ManCos will be indirectly impacted by these rules by virtue of the distributor requiring certain information about the product and target market, the product approval process and information on costs and charges, in order to comply with their target market obligations under MiFID II. Distributors will use this information and information on their own clients to identify the target market and distribution strategy to fulfil this obligation.

Product governance and distribution requirements

As part of its investor protection framework, MiFID II introduced product governance requirements for MiFID investment firms that manufacture and distribute financial instruments to ensure they act in the clients' best interests during all the stages of the life-cycle of products or services. In particular, it contains requirements for firms to establish, implement, maintain, operate and review a product approval process for each financial instrument and for significant adaptations of existing financial instruments before they are marketed or distributed/sold to an identified target market or end client.

The MiFID II Delegated Directive separates firms into the following categories (1) product manufacturers: investment firms that create, develop, issue and/or design investment products; and (2) product distributors: investment firms that offer or sell financial instruments and services to clients[1].

The product governance requirements apply to financial instruments, as defined under Annex 1 Section C of MiFID II, this extends out to all products sold on primary and secondary markets, irrespective of the type of product or service provided and the applicable requirements at the point of sale. In an asset management context, the requirements are likely to apply to shares or interests in open-ended and closed ended funds (including UCITS funds and alternative investment funds), collateralised loan obligation and other structured products that are sold to investors.

The product governance obligations may be applied in a proportionate manner, taking into account the nature, scale and complexity of a firm's business and the nature and range of financial services and activities undertaken. For simpler products, for example ordinary shares, target market will likely be identified with less detail with more complicated products, for example structured products, being identified in more detail.

ESMA has published a consultation paper on "Draft guidelines on MiFiD II product governance requirements" (the Guidelines). However, as the Guidelines focused mainly on the requirement for investment firms to identify the target market for their products and is largely framed for investment firms dealing with retail clients we have not made these Guidelines a main focus of this memo.

Product governance obligations for ManCos

As noted above, ManCos are generally exempt from MiFID II and as such the product governance provisions will apply as guidance and not as rules and on that basis the application of this aspect of MiFID II is commercial as opposed to legal. As a matter of course, ManCos using such MiFID regulated third party distributors are likely to implement product governance procedures to ensure that they are able to provide sufficient and consistent product approval and target market information to these distributors. This would include information on the product features of the fund (e.g. complexity, risk-reward profile, liquidity or innovative character) which would have an impact on the target market and the nature of the investment service provided by a distributor. However, the primary responsibility for product governance lies with the distributor and ManCos should not be required to enter into agreements with distributors that would impose product governance obligations on them.

Product governance obligations for manufacturers and distributors

Set out below is an overview of the general product governance principles for manufacturers and distributors derived from MiFID II.

Manufacturers

- Establishment of procedures and arrangements to manage conflicts of interest in design, creation and development process (including remuneration); analysis each time a financial instrument is manufactured;
- Establishment of a governance processes for effective oversight and control over design, creation, issuance and development process, including (a) ensuring that relevant staff understand the characteristics and risk of a financial instrument and (b) compliance involvement;
- Assessment of the target market of each financial instrument (taking a proportionate approach) including characteristics, needs, objectives of type of end client;
- Assessment of risks posed by products and the circumstances that may cause these to occur, including undertaking a scenario analysis;
- Consider the impact of charging structures on target market to ensure that such structures do not undermine the financial instrument's return expectations and are appropriately transparent;

[1] Recital 15, MiFID II Delegated Directive

- Provision of adequate information to distributors so they can understand and sell properly, including information about the appropriate channels for distribution of the financial instrument, the product approval process and the target market assessment;
- Regular review of the products to:
  a) ensure the product remains consistent with the needs of the target market;
  b) ensure the distribution strategy remains appropriate; and
  c) consider any event that could materially affect the risk to the target market.
- Positive obligation to check that products function as intended (rather than waiting for detriment to occur). Firms to review products (i) prior to any re-launch or re-issue; (ii) when aware of an event which could materially affect the potential risk to investors; and (iii) at regular intervals.

It should be noted that the requirements will also apply to a MiFID firm manufacturing products for distribution through a non-MiFID firm, in which case the manufacturer will need to ensure that the distributor is contractually obliged to provide information sufficient for the manufacturer to review the product and target market.

Distributors

- Determine the target market of the financial instrument for its clients;
- Establishment of a product governance processes to ensure that products and services offered are compatible with the characteristics, objectives and needs of the identified target market and that the intended distribution strategy is consistent with the target market;
- Establishment of effective procedures for oversight by the management body and compliance of the product governance process;
- Ensure that the interests of the clients are not compromised as a result of commercial or funding pressures;
- Identification of groups of clients for whose needs, characteristics and objectives the product or service is not compatible;
- Maintaining procedures and measures to ensure compliance with MiFID II including those relating to disclosure, assessment of suitability or appropriateness, inducements and proper management of conflicts of interest when deciding on a range of financial instruments and services offered or recommend and the respective target markets;
- Ensure that staff that offer products or recommendations understand the characteristics and risks of those products as well as the needs, characteristics and objectives of the target market;
- Conduct regular reviews of product governance arrangements taking into account any relevant risks and to ensure that the products and services they offer are consistent with the needs, characteristics and objectives of the identified target market and that their distribution strategy remains appropriate;
- Provision of sales information to manufacturers, to assist manufacturers in meeting their post-sale product governance responsibilities and, where appropriate, its product reviews; and
- Establishment of adequate arrangements to obtain sufficient and reliable information on the financial instruments and the product approval process including information about: (i) the financial instrument; (ii) the product approval process and (ii) the identified target market of the financial instrument from the manufacturer;
- Establishment of adequate arrangements with third-country manufacturers to ensure the level of product information obtained is of a reliable and adequate standard to ensure that products will be distributed in accordance with the characteristics, objectives and needs of the target market.

It should be noted that the final distributor in a distribution chain has the ultimate responsibility to comply with the distributor requirements, but the intermediate distributors must pass information will also have certain obligations, being to:

a) ensure the relevant product information is passed from the manufacturer down the chain;

b) enable the manufacturer to obtain information on product sales through the chain; and

c) apply the product governance obligations for manufacturers in relation to the service they provide.

Where an investment firm acts both as manufacturer and distributor of investments products, it should be required to comply with all relevant obligations for both manufacturers and distributors – if that is the same legal entity, only one single product governance process is needed.

Where a manufacturer engages a third party distributor, both firms are required to conduct a separate target market assessment and establish their own distribution strategy.

The product governance obligations under the MiFID II apply without prejudice to any assessment of suitability or appropriateness to be carried out by the investment firm before providing investment services to each client, on the basis of their personal needs, characteristics and objectives. Accordingly, a distributor may determine that it is appropriate to recommend a product to an investor outside the target market assessment based on the assessment of suitability or appropriateness of the client.

Application of product governance requirements to the distribution of financial instruments manufactured or issued before the entry into application of MIFID II

MiFID II product governance obligations are to be observed from the date of application of MiFID II (3 January 2018). The distribution, after 3 January 2018, of products manufactured before that date should be treated in the same manner as the distribution of products that have been manufactured by entities not subject to the MiFID II product governance requirements. However, a target market should be assigned by the manufacturer – when subject to MiFID II product governance requirements - to such products following the product review process that has to be conducted according to Article 16(3) of MiFID II.

Next steps and transitional arrangements

Following responses from industry on the Guidance, we believe that ESMA will issue further guidance on how distributors should deal with non-MiFID entities (including ManCos). One key point for industry is whether MiFID distributors are under an obligation to provide target market information back to a non-MiFID firm. This clarification is important for non-MiFID firms who are looking to apply MiFID II product governance good practice across all entities.

The final Level 1 texts of the MiFID II Directive and MiFIR were published in the Official Journal of the European Union on 12 June 2014. They entered into force on 2 July 2014 and had been due to enter into effect 30 months later, on 3 January 2017. This was subsequently delayed to 3 January 2018. Under the revised timeline, Member States are required to transpose the provisions of MiFID II into their national legislation by 3 July 2017.

KEY CONTACTS

Brian McDermott
Partner
+353 1 649 2307
bmcdermott@algoodbody.com

Michael Barr
Partner
+353 1 649 2327
mbarr@algoodbody.com

Mary McKenna
Partner
+353 1 649 2344
mmckenna@algoodbody.com

Niamh Ryan
Partner
+44 20 73 820 820
nryan@algoodbody.com

Elaine Keane
Partner
+353 1 649 2544
elkeane@algoodbody.com

Stephen Carson
Partner
+353 1 649 2317
scarson@algoodbody.com

Nollaig Greene
Knowledge Lawyer
+353 1 649 2359
ngreene@algoodbody.com

Hazel Doyle
Associate
+353 1 649 2457
hdoyle@algoodbody.com

John Aherne
Associate
+353 1 649 2739
jaherne@algoodbody.com