

# 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 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 implications 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<sup>1</sup>.**

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), 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 mass market products, target market will likely be identified with less detail with more complicated products, for example a highly leveraged AIF, being identified in more detail.

ESMA has published product governance guidelines which address in detail the target market assessment process.

## Product governance obligations for ManCos

As noted above, ManCos are generally exempt from MiFID II and as such the product governance provisions will be relevant 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 compliance responsibility lies with the distributor.

Where a MiFID firm, such as a sponsor or investment manager, collaborates in the manufacture of a fund with a non-MiFID firm (like a ManCo), there needs to be collaboration arrangements in place regarding the product governance requirements. This may result in some ManCos being subject to aspects of the product governance regime in practice. There are also some obvious synergies between aspects of the CP86 distribution management function which refers to requirements around having a distribution strategy and a target market.

## 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

<sup>1</sup> Recital 15, MiFID II Delegated Directive

instrument's return expectations and are appropriately transparent;

- 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 (and many asset managers are using the EFAMA endorsed European MiFID template (EMT) for this aspect);
- 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.

## 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 (iii) 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, 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 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 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

ManCos in particular where distributing through a MiFID firm or collaborating with a MiFID firm in manufacturing a fund may have the following potential impacts/actions:

- Complete a target market assessment (with reference to the EMT) in conjunction with the MiFID firm.
- Consider any variations around the existing product approval and review process and consider for instance any consequential business plan updates.
- If necessary, address any contractual impacts for distribution agreements in particular regarding information returns on sales outside the target market.
- Ensure marketing literature generally (including the UCITS KIID and prospectus) is not inconsistent with the target market assessment.

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