

MiFID II

Product governance and product intervention

January 2017

Key Points

- Firms that manufacture and/or distribute financial instruments must have arrangements in place for product governance.
- Product manufacturers must have a product approval process. The target market and performance of products should be subject to periodic review.
- Firms that offer or recommend financial instruments must ensure that their products meet the needs of the relevant client market. Distributors must ensure that products are distributed to the proper market and carry out periodic reviews to ensure that this remains the case.
- ESMA, the European Banking Authority ("EBA") and national competent authorities ("NCAs") have powers under MiFID II to prohibit or restrict the marketing, distribution or sale of financial instruments, or particular financial activities or practices
- There are detailed criteria to determine when the supervisory authorities and regulators may intervene to ban or restrict certain financial products, services or activities.

Product governance

MiFID I sets out a high-level framework for investment firms' organisational requirements. At present, firms are required to:

- establish policies and procedures sufficient to ensure compliance with their MiFID obligations as well as appropriate rules for personal account dealing; and
- have effective arrangements to prevent conflicts of interest from adversely affecting the interests of their clients.

However, the European Commission's MiFID consultation review in December 2010 identified a need for more specific requirements to protect investors.¹ In particular, the Commission proposed that firms should be required to have appropriate policies and

¹ European Commission, Public consultation: Review of the Markets in Financial Instruments Directive (MiFID), 8 December 2010, paragraph 7.3.3.

controls to ensure that product design and sale and distribution would not be detrimental to clients' interests. The consultation suggested the following modifications to the MiFID

Implementing Directive:

- Firms would be required to run an assessment of the compatibility of a product, service or operation with its intended client base.
- The requirement on the compliance function to ensure that the product, service or operation complied with all applicable rules would be strengthened.
- Firms would have to manage adequately the risks relating to any new product, service or operation.
- Firms would have to stress test their products and services as appropriate.
- Firms should periodically review the distribution and performance of products and services.
- Firms should ensure staff have the necessary expertise in relation to the products and service, and receive appropriate training on new products.
- The board should have effective control over this area, with appropriate information supplied to it by the compliance function on request.

Detailed provisions relating to the requirements placed on firms for product governance are set out in the MiFID II Delegated Directive.²

Governance requirements for manufacturers and distributors

Following the MiFID I review, MiFID II now includes specific requirements relating to the manufacture and distribution of financial instruments. In line with the obligation to act in the best interests of their clients and comply with their MiFID obligations, investment firms should:

² Commission Delegated Directive of 7 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision of reception of fees, commissions or any monetary or non-monetary benefits (the "MiFID II Delegated Directive")

- understand the features of financial instruments that they offer or recommend;
- establish and review policies and arrangements to identify the category of clients targeted;
- ensure that any products which they manufacture:
 - meet the needs of identified target markets of end clients;
 - take reasonable steps to ensure that the products are distributed to this target market; and
 - periodically review the identification of target market and the performance of products; and
 - ensure that, in relation to any products which they offer or recommend (but have not manufactured), they obtain relevant information on the product approval process.³

MiFID II requires firms to take all reasonable steps to prevent conflicts of interest from adversely affecting their clients. In terms of product governance, this requires firms manufacture financial instruments to:

- operate and review a product approval process for new financial instruments and for significant adaptations of existing instruments. This product approval process must specify an identified target market of clients and ensure that relevant risks to this target market are assessed, and that the intended distribution strategy remains appropriate;
- make appropriate information on the financial instrument and the product approval process available to distributors.⁴

According to the MiFID II rules on investor protection, a firm that manufactures financial instruments for sale to clients must ensure that:

- the financial instruments are designed to meet the needs of an identified target market of end clients;

- the strategy for distribution of the financial instruments is compatible with the target market; and
- it takes reasonable steps to ensure that the financial instrument is distributed to that target market.⁵

In addition, a firm that offers or recommends a financial instrument must:

- assess the compatibility of the financial instrument with the needs of its clients; and
- ensure that the instruments are only offered or recommended when this is in the clients' interests.⁶

ESMA advice on product governance

In its technical advice, ESMA stated that the product governance requirements are intended to enhance investor protection by introducing specific obligations in relation to oversight, control and governance for firms that manufacture and/or distribute financial instruments. This will ensure that new products and services are marketed or provided to the right investors.⁷

Manufacturers and distributors

The MiFID II Delegated Directive separates firms into the following categories:⁸

- firms that create, develop, issue and/or design products should be considered as manufacturers; and
- firms that offer or sell financial instruments and services to clients should be considered as distributors.

The MiFID II Delegated Directive confirms that if a firm is both a manufacturer and distributor, it must comply with the requirements for both categories, although it may do this using a single process rather than duplicating its procedures.⁹

³ Recital 71, MiFID II Directive.

⁴ Article 16(3), MiFID II Directive.

⁵ Article 24(2), MiFID II Directive.

⁶ Article 24(2) MiFID II Directive.

⁷ ESMA Final Report: ESMA's Technical Advice to the Commission on MiFID II and MiFIR, published 19 December 2014 (the "**Technical Advice**").

⁸ Recital 15, MiFID II Delegated Directive.

⁹ Recital 17, MiFID II Delegated Directive.

Product manufacturers

In relation to product manufacturers, the MiFID II Delegated Directive¹⁰ provides that firms are required to:

- establish, implement and maintain procedures and measures to ensure the manufacture complies with requirements on conflicts of interests, including remuneration;
- analyse potential conflicts of interests each time a product is manufactured;
- consider whether the product poses a threat to the orderly functioning or stability of financial markets, before deciding to launch the product;
- ensure relevant staff have the necessary expertise to understand the characteristics and risks of the products they manufacture;
- ensure the management body has effective control over the product governance process;
- ensure that compliance monitor the development and periodic review of product governance arrangements;
- where there is any collaboration with another firm, to outline the mutual responsibilities of each party in a written agreement;
- identify the potential target market, including the type of client a product is compatible for;
- assess the risks of poor investor outcomes;
- consider the charging structure proposed for the product;
- provide adequate information to distributors; and
- regularly review the products.

There is some further detail about when a product manufacturer would be expected to review the products. A firm would be required to carry out a review of the products it manufactures:

- prior to any re-launch or further issue;

- when aware of any event that could materially affect the potential risk to investors; and
- at regular intervals determined by the firm. This will require the firms to consider the complexity or innovative nature of the investment strategies.¹¹

Product distributors

The MiFID II Delegated Directive¹² sets out requirements for product distributors. These require distributors to:

- determine the target market for the financial instrument, even if the target market was not defined by the product manufacturer, and reconsider the target market if they become aware it was initially wrongly identified for a product;
- gain the necessary understanding and knowledge of the products from manufacturers to ensure that these products will be distributed in accordance with the needs, characteristics and objectives of the identified target market;
- periodically review and update their product governance arrangements to ensure they remain robust and fit for purpose;
- review the products offered on a regular basis, taking into account any event that could affect the potential risk to the target market;
- have in place adequate product governance arrangements to ensure that their products and services, and their distribution strategy, continue to match the intended target market;
- appropriately identify and assess the circumstances and needs of the clients they intend to focus on, to ensure the clients' interests are not compromised as a result of commercial or funding pressures;
- provide sales information, and other information as necessary, to manufacturers to assist them with their product reviews;
- involve the compliance function in overseeing the product governance arrangements;

¹⁰ Article 9, MiFID II Delegated Directive.

¹¹ Article 9(15), MiFID II Delegated Directive.

¹² Article 10, MiFID II Delegated Directive.

- ensure that the management body of the firm has effective control over the firm's product governance arrangements, including systematically including information about the products offered in compliance reports to the management body; and
- (where products are manufactured or issued by firms outside Europe or by non-MiFID firms) take reasonable steps to ensure that the information obtained from the manufacturer/issuer is adequate.¹³

In some circumstances, different firms may work together to distribute a product. The MiFID II Delegated Directive clarifies that the firm with the direct client relationship will have ultimate responsibility for meeting the product governance obligations. However, other firms in the chain will have responsibilities to pass on information to the final distributor and to the manufacturer, and to apply the governance requirements applicable to manufacturers, where applicable.¹⁴

Product intervention

Articles 40 to 43 of the Markets in Financial Instruments Regulation ("MiFIR") permit regulators to ban or restrict the marketing, distribution or sale of certain financial products, or to intervene in relation to certain financial activities.

MiFIR sets out the conditions when ESMA, the EBA or NCAs may be able to intervene in this way. These include:

- the existence of a significant investor protection concern, a threat to the orderly functioning and integrity of financial markets or commodity markets, or a threat to the stability of the whole or part of the financial system in the EU;
- the absence of EU regulatory requirements to address the threat; and
- (in the case of ESMA and the EBA) the failure by NCAs adequately to address the threat.¹⁵

There are limits on the ability of the regulators to intervene in the market. For example, among other restrictions, any intervention should not:

- have a detrimental effect on market efficiency of financial markets or on investors that is disproportionate to the benefits of the action; or
- create a risk of regulatory arbitrage.

Criteria for product intervention

The MiFIR Delegated Regulation¹⁶ sets out the criteria and factors which should be used to assess whether ESMA, the EBA or NCAs can intervene in a product.

These criteria and factors include:

- the degree of complexity of a financial instrument or structured deposit and the relation to the type of client to whom it is marketed, distributed and sold;
- the size of potential detrimental consequences;
- the type of clients involved in a financial activity or financial practice, or to whom a financial instrument is marketed or sold;
- the degree of transparency of the product;
- the particular features or components of the product, including any embedded leverage;
- the existence and degree of disparity between expected returns or profits, and the risk of loss;
- the ease and cost of selling the product or switching to a different product;
- the pricing and other associated costs;
- the degree of innovation of a financial instrument or structured deposit, an activity or a practice; and
- whether a structured deposit or financial product poses particular risk to the market or payment systems infrastructure.

¹³ Article 10(2), MiFID II Delegated Directive.

¹⁴ Article 10(10), MiFID II Delegated Directive.

¹⁵ Articles 40 and 41, MiFID II Directive.

¹⁶ Commission Delegated Regulation of 18 May 2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council with regard to definitions, transparency, portfolio compression and supervisory measures on product intervention and positions (the "**MiFIR Delegated Regulation**"), specifically Articles 19 to 21.

Timescales for implementation

The MiFID II Directive and MiFIR came into force on 3 July 2014, and most of their provisions will come into effect in member states from 3 January 2018. Member states have until July 2017 to transpose the MiFID II Directive into national law.

The MiFID II Delegated Directive will become effective from 3 January 2018. Member states will be required to implement the provisions into national law.

The MiFIR Delegated Regulation will also become effective from 3 January 2018. It will have direct effect and the member states will not need to implement these changes into national law.

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