



MiFID II - Product Governance

The product governance rules under MiFID II, including guidelines issued by ESMA, take effect from 3 January 2018. The new regime represents a fundamental change to European financial product distribution and will be challenging for firms to implement. Manufacturers and distributors of financial products and services will have to put in place robust processes for the design of financial products and services, the identification of target investors (the “target market”) and the ongoing monitoring of distribution activities. Manufacturers will have to oversee distributors and sub-distributors to ensure compliance with their distribution strategies. The regime has been supplemented by new product intervention powers for national competent authorities, ESMA and the EBA.

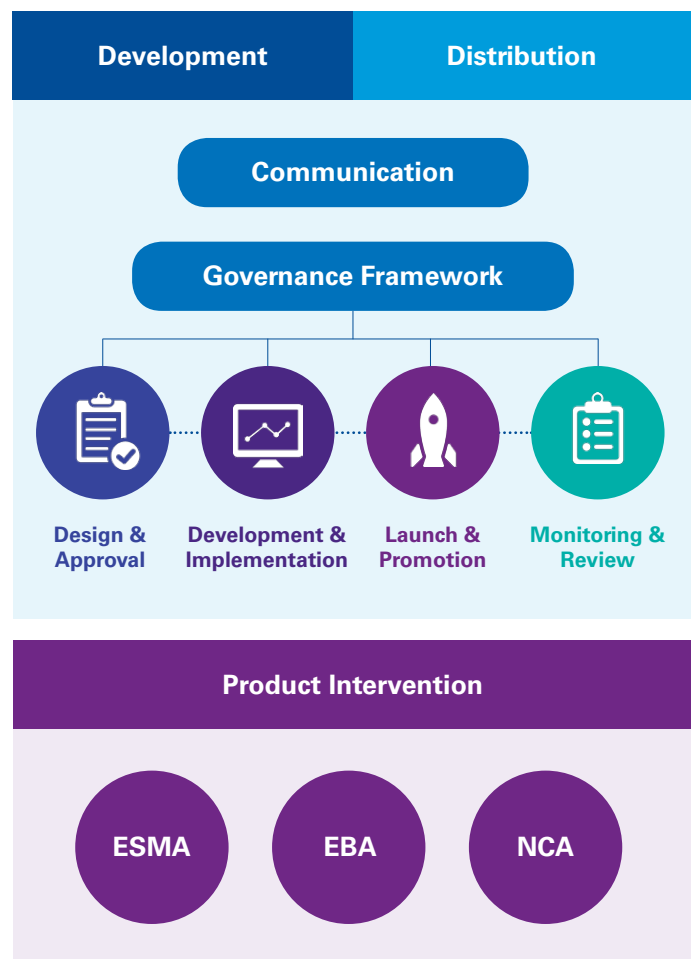
What types of firms are impacted?

- Investment firms (e.g. brokers, asset managers), market operators (including trading venues, such as exchanges and multi-lateral trading facilities) and data reporting service providers (e.g. Authorised Reporting Mechanisms and other reporting services)
- Third country firms providing investment services or performing investment activities through the establishment of a branch in the EU or by way of direct access to clients in Member States, once the third country passport has been activated.
- Credit institutions (banks) providing or performing investment services.
- Undertakings for Collective Investment in Transferable Securities (UCITS) management companies or Alternative Investment Fund Managers (AIFMs) when providing MiFID investment services (individual portfolio management, reception and transmission of orders and investment advice).
- Indirect impact on all UCITS and AIFMs that interact with MiFID firms in their distribution channels
- Distributors and sub-distributors throughout the distribution chain

Why have these new rules been introduced?

Negative outcomes for investors can be attributed to two factors: poor manufacturing of products and services or poor advice. Furthermore European regulators have come to the conclusion that current practices in relation to product development and distribution are not always focused on the client’s best interest. To address these shortcomings MiFID II introduces this new product governance regime that aims to regulate the entire product lifecycle.

There are two key components to this regime: Firstly, manufacturers and distributors need to put a governance framework in place around the development and placement of products that puts the client at the forefront. Secondly, MiFID II introduces new product intervention powers for national competent authorities, ESMA and the EBA



Roles and responsibilities for product development and distribution

For the purpose of product governance, investment firms that create, develop, issue and/or design financial instruments, including when advising corporate issuers on the launch of new financial instruments, are considered to be manufacturers while investment firms that offer or sell financial instruments and services to clients are considered distributors.

The product governance requirements contained in the Delegated Directive 2017/593 dated 7 April 2016 impact both manufacturers as well as distributors and sub-distributors and define obligations along the four distinct phases of the product governance cycle: Design and Approval, Development and Implementation, Launch and Promotion and Monitoring and Review.

These obligations can be summarised as follows:

	Manufacturers	Distributors
Design and approval	<p>Must identify the target market based on an assessment of end clients for whose needs and objectives the product is intended, taking considerations such as the nature of the product and charging structures into account</p> <p>Must approve and communicate the target market information to distributors and undertake scenario analysis (such as stress testing).</p> <p>Must ensure that risks to financial stability are not created</p>	<p>Must obtain confirmation from manufacturers that there is a product approval process in place that covers the target market. Distributors need this information to understand the product and ensure it is suitable for distribution to the distributor's own identified target market.</p>
Development and implementation	<p>Should ensure sufficient information is given to distributors and that staff are properly trained and have knowledge of the product.</p> <p>Where they collaborate with entities which are not authorised and supervised in accordance with MiFID II (including third-country firms) to create, develop, issue and/or design a product, manufacturers must outline their mutual responsibilities in a written agreement.</p>	<p>Where manufacturers are not subject to MiFID II, distributors must inform themselves with adequate and reliable information about the product to ensure that it will be distributed in accordance with the characteristics, objectives and needs of the distributor's target market. Where relevant information is not publicly available, the distributor must take all reasonable steps to obtain such relevant information from the manufacturer or its agent.</p>
Launch and promotion	<p>Must have a process in place to ensure compliance with requirements and to highlight new risks, if applicable.</p>	<p>Must review their product governance requirements regularly and ensure that their distribution strategy is consistent with the identified target market. Distributors shall provide manufacturers with information on sales.</p>
Monitoring and review	<p>Must receive management information back from the distributor in relation to the product to ensure it is being sold to the appropriate target market.</p>	<p>Must reconsider the target market and/or update the product governance arrangements if they become aware that they have incorrectly identified the target market for a specific product or service or that the product or service no longer meets the circumstances of the identified target market, for example, where the product becomes illiquid or very volatile due to market changes.</p>

Where there is a distribution chain, MiFID II requires product manufacturers to consider their responsibilities to the ultimate end client rather than treating distributors as the clients. Distributors need to ensure that relevant product information flows along the distribution chain.

Other obligations

In addition to the specific requirements at each stage there are other obligations for manufacturers and distributors to consider such as:

- Putting procedures and arrangements in place to ensure that conflicts of interest are properly managed including where the firm wants to or does hold an opposite exposure to the end client;
- Establishing governance processes including board oversight to ensure effective control over the manufacturing process and ensuring that staff possess the necessary expertise to understand the characteristics and risks of the financial instruments they intend to manufacture.
- Ensuring that the compliance function monitors the development and periodic review of product governance arrangements in order to detect any risk of failure by the firm to comply with the obligations
- Ensuring that the target market is identified. As part of this process, manufacturers and distributors are also required to identify a negative target market i.e. clients for whom the product is unsuitable
- Devising an appropriate stress testing mechanism to assess how extreme circumstances would impact the performance of the product
- Putting a process in place to ensure that products will be reviewed on at least an annual basis

ESMA Guidelines on MiFID II on Product Governance Requirements

ESMA has recently published its guideline on product governance in order to ensure a consistent application of the rules and in particular to provide clarity in relation to the target market assessment.

Manufacturers

- The guidelines set out five different criteria the manufacturer should consider when identifying the target market – client type, knowledge and experience, financial situation, risk tolerance, clients objectives and needs. In the absence of specific client information, the manufacturer’s assessment of the target market may be rather abstract (“theoretical target market”);

- Manufacturers also need to define their distribution strategy and select distributors whose clients and services are aligned with the manufacturer’s identified target market. In order to do this the manufacturer should specify the type of investment service by which the product could be sold (for example execution only, advisory, discretionary) and may also further specify the distribution channel (face to face, telephone, online etc).
- ESMA has clarified that for more complicated products, such as structured products with complicated return profiles, the target market should contain more detail. For simpler, more common products such as non-comple UCITS, less detail is required.

Distributors

- Distributors should use the same five criteria to further specify the target market within the parameters set by the manufacturer, incorporating information about their client base (“actual target market”);
- They must ensure that there is a governance process in place at an early stage to define the distribution strategy. The primary objective of this oversight is to make sure that a product is only included in the distributor’s product range where it is aligned with the type of service the distributor provides.

For example, for execution only services, limited information will be available to the distributor about the end client, which would impact the types of products it could offer. In such a scenario it would be unlikely to sell complex products to clients.

- The identification of the target market is a separate responsibility to that of conducting a suitability or appropriateness test for each individual client within that target market.

Manufacturers and Distributors

- Both parties must consider the identification of a negative target market. The guidelines usefully clarify that products can be sold within this negative target market but only in justified, rare circumstances, for example, for distributors where the client is investing as part of a diversified portfolio approach or for hedging purposes. Beyond this exemption, sales to the negative target market must be reported by the distributor to the manufacturer. The manufacturer will have to decide based on the specific facts of the case if remedial action should be taken.
- Both parties must regularly review products. Manufacturers must have a process in place to consider what information they need for this review and how to obtain it and distributors must have a process in place to provide manufacturers with this information. The guidelines set out the type of information which needs to be exchanged.

Impact on firms

Firms should not underestimate the complexity of implementing product governance properly especially in the context of operating on a cross-border basis and across entities. The most significant impacts on a firm will be in the following, two areas;

- Governance over the product/service lifecycle
- Data management

Governance over the product/service lifecycle

For manufacturers an appropriate governance forum, to oversee the product manufacturing process, will need to be put in place. This forum should include representatives from a broad range of functions, for example, risk management for product testing, marketing and sales for the definition

of the target market or compliance to monitor potential conflicts of interest. Within groups, the governance forum will also need to include representatives from jurisdictions across the distribution chain.

Oversight will need to be exercised in respect of all aspects, of the product manufacturing process, as set out in the diagram below. There will need to be a mechanism to approve the product before it is released into the market.

For distributors, it is crucial that they integrate the manufacturer's specifications, relating to target market, distribution strategy etc, into their existing sales process, see an example process below. Specifically, the target market specifications of manufacturers will form the confines within which the distributor can define its own more specific target market, based on a better knowledge of the end client. Also distributors will need to monitor adherence to the target market.

Manufacturer



Distributor



Data Management

Both manufacturers and distributors will need to establish processes to ensure effective interaction in order to satisfy all of the information flows introduced by MiFID II. For example distributors will have to systematically collect sales data, such as units and volumes, and relay that information back to the manufacturer. Distributors should also share feedback from clients regarding the appropriateness of products and services, expectations and complaints.

The most significant challenge in this regard is the absence of a standardised data format that facilitates the efficient production, ingestion and analysis of data. In particular manufacturers with broad distribution networks are facing the risk of being inundated with data in varying formats.

Product governance requirements may add to the headache of international distribution, especially in the short run and in particular for manufacturers with extensive distribution networks. As a result, the range of products on offer may decrease, especially for retail investors. However, as practices and data standards evolve, it should transpire that manufacturers and distributors understand investors better and offer products more suited to their needs.

Product intervention powers

Running alongside the product governance obligations on firms are new formal product intervention powers for supervisory authorities at a national and EU level.

Under these powers, the national regulator of a Member State may prohibit or restrict:

1. marketing or distribution of a particular instrument (including structured deposits); or
2. any type of financial practice, in or from that Member State.

The Member State national regulator may only take action if it is satisfied on reasonable grounds:

- that there is a significant investor protection concern or a threat to the orderly functioning and integrity of financial or commodity markets or stability of the whole or part of the financial system;
- existing regulatory requirements do not sufficiently address the risks and enhanced supervision or enforcement of existing requirements would not address the issue; and

- the action is proportionate given the risk, sophistication of investors or market participants and the effect of the action on investors and the market participants.

Both ESMA and the EBA have similar powers, ESMA's cover financial instruments and the EBA's cover structured deposits.

While these product intervention powers will only be used in specific circumstances, which have yet to be determined, it is likely that they along with the product governance requirements will significantly reshape the way firms develop and distribute financial products and services.

Contact us for more MiFID guidance



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