

Product governance: MiFID

Chapter 3

Product governance: MiFID

3.1 General

[Note: ESMA has also issued guidelines: Guidelines on MiFID II product governance requirements, 05/02/2018, ESMA35-43-620]

Interpretation: financial instruments and structured products

3.1.1 **R** For the purposes of ■ PROD 3, references to *financial instruments* include *structured deposits*.

Proportionate application of rules

3.1.2 **R**

- (1) A *firm* must, when *manufacturing financial instruments* or deciding on the range of *financial instruments* and *investment services* it intends to *distribute to clients*, comply, in a way that is appropriate and proportionate, with the requirements set out in this chapter.
- (2) In complying with these requirements, a *firm* must take into account:
 - (a) the nature of the *financial instrument* or *investment service*; and
 - (b) the target market for the *financial instrument*.

[Note: articles 9(1) and 10(1) of the *MiFID Delegated Directive*]

3.1.3 **G** A proportionate application of the requirements in this chapter may mean that complying with the *rules* could be relatively simple for simple *financial instruments* distributed on an *execution-only transaction* basis where such *financial instruments* would be compatible with the needs and characteristics of the mass retail market.

3.2 Manufacture of products

General

3.2.1

R

A manufacturer must:

- (1) ensure that the *financial instruments* it manufactures are designed to meet the needs of an identified target market of *end clients* within the relevant category of *clients* (see ■ COBS 3 for client categories);
- (2) ensure that the strategy for *distribution* of the *financial instruments* is compatible with the identified target market; and
- (3) take reasonable steps to ensure that the *financial instrument* is distributed to the identified target market.

[Note: article 24(2) of *MiFID*]

3.2.2

G

Consideration of target market factors should permeate all aspects of product development and *distribution*, as well as ensuring the selection of appropriate *distribution* channels and the promotion of the *financial instruments* are accompanied by sufficient and correct information.

Product governance arrangements

3.2.3

R

A manufacturer must maintain, operate and review a process for the approval of:

- (1) each *financial instrument*, and
- (2) significant adaptations of existing *financial instruments*,

in each case before they are marketed or *distributed* to *clients*.

[Note: article 16(3) of *MiFID*]

3.2.4

R

For each *financial instrument* the product approval process must:

- (1) specify an identified target market of *end clients* within the relevant category of *clients* (see ■ COBS 3 for client categories);
- (2) ensure that all relevant risks to the identified target market are assessed; and

(3) ensure that the intended *distribution* strategy is consistent with the identified target market.

[Note: article 16(3) of *MiFID*]

3.2.5 **G** When designing *financial instruments*, a *firm* should have in place systems and controls to manage adequately the risks posed by *financial instrument* design.

Manufacture by more than one firm

3.2.6 **R** Where *firms* collaborate to *manufacture a financial instrument*, only one target market needs to be identified.

[Note: article 9(9) of the *MiFID Delegated Directive*]

3.2.7 **R** Where *firms* collaborate, including with entities which are not authorised and supervised in accordance with *UK* provisions implementing *MiFID* or *third country investment firms*, to create, develop, issue and/or design a *financial instrument*, they must outline their mutual responsibilities in a written agreement.

[Note: article 9(8) of the *MiFID Delegated Directive*]

Target market

3.2.8 **R** *Manufacturers* must identify the potential target market for each *financial instrument* at a sufficiently granular level and must:

- (1) specify the type or types of *client* for whose needs, characteristics and objectives the *financial instrument* is compatible; and
- (2) identify any group or groups of *client* for whose needs, characteristics and objectives the *financial instrument* is not compatible.

[Note: article 9(9) of the *MiFID Delegated Directive*]

3.2.9 **G** The level of granularity of the target market and the criteria used to define the target market and determine the appropriate *distribution* strategy should be relevant for the *financial instrument* and should make it possible to assess which *clients* fall within the target market. For simpler, more common *financial instruments*, the target market could be identified with less detail while for more complicated *financial instruments* such as bail-inable instruments or less common *financial instruments*, the target market should be identified with more detail.

[Note: recital 19 of the *MiFID Delegated Directive*]

3.2.10 **R** *Manufacturers* must determine for each *financial instrument* they *manufacture*, whether it meets the identified needs, characteristics and objectives of the target market, and in doing so must include an examination of the following elements:

- (1) whether the *financial instrument's* risk/reward profile is consistent with the target market; and

- (2) whether the design of the *financial instrument* is driven by features that benefit the *client* and not by a business model which relies on poor *client* outcomes to be profitable.

[Note: article 9(11) of the *MiFID Delegated Directive*]

- 3.2.11 **R** *Manufacturers of financial instruments* that are *distributed* through other *firms* must determine the needs and characteristics of the *clients* for whom the product is compatible based on:

- (1) their theoretical knowledge of, and past experience with, the *financial instrument* or similar *financial instruments*;
- (2) the financial markets, and
- (3) the needs, characteristics and objectives of potential *end clients*.

[Note: article 9(9) of the *MiFID Delegated Directive*]

Product testing

- 3.2.12 **R** *Manufacturers* must undertake a scenario analysis of their *financial instruments* to assess:

- (1) the risks of poor outcomes for *end clients* posed by the *financial instrument*; and
- (2) in which circumstances those poor outcomes may occur.

[Note: article 9(10) *MiFID Delegated Directive*]

- 3.2.13 **R** In conducting the scenario analysis *manufacturers* must assess their *financial instruments* under negative conditions covering what would happen if, for example:

- (1) the market environment deteriorated; or
- (2) the *manufacturer* or a third party involved in *manufacturing* and/or the functioning of the *financial instrument* experiences financial difficulties or other counterparty risk materialises; or
- (3) the *financial instrument* fails to become commercially viable; or
- (4) demand for the *financial instrument* is much higher than anticipated, putting a strain on the *firm's* resources and/or on the market of the underlying *financial instrument*.

[Note: article 9(10) *MiFID Delegated Directive*]

- 3.2.14 **R** *Manufacturers* must consider the charging structure proposed for each *financial instrument*, including examination of the following:

- (1) whether the *financial instrument's* costs and charges are compatible with the needs, objectives and characteristics of the target market;

(2) whether the charges undermine the *financial instrument's* return expectations, such as where the costs or charges equal, exceed or remove almost all the expected tax advantages linked to a *financial instrument*; and

(3) whether the charging structure of the *financial instrument* is appropriately transparent for the target market, such as that it does not disguise charges or is too complex to understand.

[Note: article 9(12) of the *MiFID Delegated Directive*]

3.2.15

R

Manufacturers must consider whether the *financial instrument* may represent a threat to the orderly functioning, or to the stability, of financial markets before deciding to proceed with the launch of the *financial instrument*.

[Note: article 9(4) of the *MiFID Delegated Directive*]

Information disclosure to distributors

3.2.16

R

A *manufacturer* must make available to any *distributor* of that *financial instrument*:

- (1) all appropriate information on the *financial instrument*;
- (2) all appropriate information on the product approval process;
- (3) the identified target market of the *financial instrument*, including information about the target market assessment undertaken;
- (4) information about the appropriate channels for *distribution* of the *financial instrument*;

and must ensure that the information is of an adequate standard to enable *distributors* to understand and recommend or sell the *financial instrument* properly.

[Note: article 16(3) of *MiFID II* and 9(13) of the *MiFID Delegated Directive*]

3.2.17

G

When providing information to *distributors*, a *manufacturer* should make it clear if that information is not intended for *end client* use.

3.2.18

G

Manufacturers may consider, for example, with regard to each *distribution* channel or type of *distributor* what information *distributors* of that type already have, their likely level of knowledge and understanding, their information needs and what form or medium would best meet those needs (which could include discussions, written material or training as appropriate).

Review of financial instruments

3.2.19

R

(1) A *manufacturer* must regularly review the *financial instruments* it *manufactures* taking into account any event that could materially affect the potential risk to the identified target market.

(2) In doing so, a *manufacturer* must assess for each *financial instrument* at least the following:

- (a) whether the *financial instrument* remains consistent with the needs, characteristics and objectives of the identified target market;
- (b) whether the intended *distribution* strategy remains appropriate;
- (c) whether the *financial instrument* is being *distributed* to the target market; and
- (d) whether the *financial instrument* is reaching *clients* for whose needs, characteristics and objectives the *financial instrument* is not compatible.

[Note: article 16(3) of *MiFID II* and article 9(14) of the *MiFID Delegated Directive*]

3.2.20 **G** In carrying out the reviews in **■ PROD 3.2.19R** *manufacturers* should collect and analyse appropriate management information to detect patterns in *distribution* as compared with the planned target market in order to assess the performance of the *distribution* channels through which a *financial instrument* is being *distributed*.

- 3.2.21** **G**
- (1) When reviewing the *financial instruments* it manufactures, a *firm* should communicate to the *end client* contractual “breakpoints” such as the end of a long tie-in period that may have a material impact on the *end client* that the *end client* cannot reasonably be expected to recall or know about already.
 - (2) If the *manufacturer* does not know the identity of the *end client*, it should communicate any contractual breakpoints to the *distributor*.

- 3.2.22** **R** *Manufacturers* must:
- (1) review *financial instruments* prior to any further issue or re-launch if they are aware of any event that could materially affect the potential risk to *clients*; and
 - (2) identify crucial events that would affect the potential risk or return expectations of the *financial instrument*.

- 3.2.23** **G** Crucial events that would affect the potential risk or return expectations of the *financial instrument* include:
- (1) the crossing of a threshold that will affect the return profile of the *financial instrument*; or
 - (2) the solvency of certain issuers whose securities and guarantees may impact the performance of the *financial instrument*.

- 3.2.24** **R** When a crucial event affecting the potential risk or return expectation of the *financial instrument* occurs, a *manufacturer* must take appropriate action, which may consist of:
- (1) the provision of any relevant information on the event and its consequences on the *financial instrument* to the *clients* or *distributors*

of the *financial instrument* if the *manufacturer* does not offer or sell the *financial instrument* directly to the *clients*;

- (2) changing the product approval process;
- (3) stopping further issuance of the *financial instrument*;
- (4) changing the *financial instrument* to avoid unfair contract terms;
- (5) considering whether the sales channels through which the *financial instrument* is sold are appropriate where the *manufacturer* becomes aware that the *financial instrument* is not being sold as envisaged;
- (6) contacting the *distributor* to discuss a modification of the *distribution* process;
- (7) terminating the relationship with the *distributor*; or
- (8) informing the *FCA*.

3.2.25 **R** *Manufacturers* must review *financial instruments* at regular intervals to assess whether they function as intended.

3.2.26 **R** *Manufacturers* must determine how regularly to review their *financial instruments* based on relevant factors including factors linked to the complexity or the innovative nature of the investment strategies pursued.
[Note: article 9(15) of the *MiFID Delegated Directive*]

Conflicts of interest

3.2.27 **R** *Manufacturers* must establish, implement and maintain procedures and measures to ensure the *manufacture of financial instruments* complies with the requirements on proper management of conflicts of interest (see ■ SYSC 10.1.7R), including *remuneration*.

3.2.28 **R** *Manufacturers* must ensure that the design of each *financial instrument*, including its features, does not:

- (1) adversely affect *end clients*; or
- (2) lead to problems with market integrity by enabling the *firm* to mitigate and/or dispose of its own risks or exposure to the underlying assets of the product where the *firm* already holds the underlying assets on own account.

[Note: article 9(2) of the *MiFID Delegated Directive*]

3.2.29 **R** Each time a *financial instrument* is *manufactured* *manufacturers* must analyse potential conflicts of interests.

3.2.30 **R** In analysing potential conflicts of interest *manufacturers* must assess whether the *financial instrument* creates a situation where *end clients* may be adversely affected if *end clients* take:

- (1) an exposure opposite to the one previously held by the *manufacturer* itself; or
- (2) an exposure opposite to the one that the *manufacturer* wants to hold after the sale of the product.

[Note: article 9(3) of the *MiFID Delegated Directive*]

Oversight and training requirements

3.2.31 **R** *Manufacturers* must ensure that their *management bodies* have effective control over their product governance process.

3.2.32 **R** The development and periodic review of product governance arrangements must be monitored by the *person* allocated the *compliance oversight function* of a *firm* in order to detect any risk of failure by the *manufacturer* to comply with applicable provisions of *PROD*.

[Note: article 9(6) and article 9(7) of the *MiFID Delegated Directive*]

3.2.33 **R** All relevant staff involved in the *manufacturing of financial instruments* must possess the necessary expertise to understand the characteristics and risks of the *financial instruments* they intend to *manufacture*.

[Note: article 9(5) of the *MiFID Delegated Directive*]

3.2.34 **G** *Firms* should have regard to **SYSC 5.1**, and in particular **SYSC 5.1.5AB R**, when considering whether their relevant staff have the necessary expertise.

Compliance reports

3.2.35 **R** Compliance reports to the *management body* must include information about the *financial instruments* that the *firm* has *manufactured*, including information on the *distribution* strategy.

3.2.36 **R** *Manufacturers* must make the compliance reports available to the *FCA* on request.

[Note: article 9(6) *MiFID Delegated Directive*]

3.3 Distribution of products and investment services

General

3.3.1

R

A distributor must:

- (1) understand the *financial instruments* it distributes to clients;
- (2) assess the compatibility of the *financial instruments* with the needs of the *clients* to whom it distributes investment services, taking into account the *manufacturer's* identified target market of *end clients*; and
- (3) ensure that *financial instruments* are distributed only when this is in the best interests of the *client* (see ■ COBS 2.1.1R(1)).

[Note: article 24(2) of MiFID]

3.3.2

G

A distributor should consider what impact the selection of a given *manufacturer* could have on the *end client* in terms of charges or the financial strength of the *manufacturer*, or possibly, where information is available to the *distributor*, how efficiently and reliably the *manufacturer* will deal with the *distributor* or *end client* at the point of sale (or subsequently, such as when queries/complaints arise, claims are made, or a *financial instrument* reaches maturity).

Obtaining information from manufacturers

3.3.3

R

Distributors must obtain from *manufacturers* subject to ■ PROD 3.2 information to gain the necessary understanding and knowledge of the *financial instruments* they intend to distribute in order to ensure that the *financial instruments* will be distributed in accordance with the needs, characteristics and objectives of the target market.

[Note: article 16(3) MiFID and article 10(2) MiFID Delegated Directive]

3.3.4

G

In ensuring that they have obtained sufficient information about the *financial instruments* they distribute and in ensuring they understand the *financial instruments* or *investment services* distributed, distributors:

- (1) should consider whether they understand the materials provided by the *manufacturer* or *distributor* earlier in the sales chain;

- (2) should ask the *manufacturer* to supply additional information or training where this seems necessary to understand the *financial instrument* or *investment service* adequately;
- (3) should not *distribute* the *financial instrument* or *investment service* if they do not understand it sufficiently; and
- (4) when providing information to another *distributor* in a distribution chain, should consider how the further *distributor* will use the information, such as whether it will be given to *end clients*. *Firms* should consider what information the further *distributor* requires and the likely level of knowledge and understanding of the further *distributor* and what medium may suit it best for the transmission of information.

Distributing financial instruments manufactured by firms to whom PROD 3.2 does not apply including third country firms

3.3.5

R

- (1) *Distributors* must take all reasonable steps to comply with ■ PROD 3.3 when *distributing financial instruments manufactured* by any *firm* to which product governance requirements in ■ PROD 3.2 do not apply.
- (2) As part of this, *distributors* must put in place effective arrangements to ensure that they obtain sufficient, adequate and reliable information from the *manufacturer* about the *financial instruments* to ensure that they will be *distributed* in accordance with the characteristics, objectives and needs of the target market.
- (3) This *rule* applies to *financial instruments* sold on either the primary or secondary market.

3.3.6

R

The obligation to obtain adequate and reliable information applies proportionately depending on:

- (1) the degree to which publicly available information is obtainable; and
- (2) the complexity of the *financial instrument*.

[Note: articles 10(1) and 10(2) of the *MiFID Delegated Directive*]

3.3.7

R

Where information relevant to the obligation in ■ PROD 3.3.5R is not publicly available, *distributors* must take all reasonable steps to obtain such relevant information from the *manufacturer* or its agent.

3.3.8

G

Acceptable publicly available information is information which is clear, reliable and produced to meet regulatory requirements, such as disclosure requirements under the *transparency rules* or the *Prospectus Regulation*.

[Note: article 10(2) of the *MiFID Delegated Directive*]

Target market and distribution strategy

- 3.3.9** **R** *Distributors* must determine the target market for the respective *financial instrument*, even if the target market was not defined by the *manufacturer*.
[Note: article 10(1) of the *MiFID Delegated Directive*]
- 3.3.10** **R** *Distributors* must identify the target market and their *distribution* strategy using:
- (1) the information obtained from *manufacturers*; and
 - (2) information they have on their own *clients*.
- 3.3.11** **G** In identifying the target market and creating a *distribution* strategy, *distributors* should consider:
- (1) the nature of the *financial instruments* to be offered or recommended and how they fit with *end clients'* needs and risk appetite;
 - (2) the impact of charges on *end clients*;
 - (3) the financial strength of the *manufacturer*; and
 - (4) where information is available on the *manufacturer's* processes, how efficiently and reliably the *manufacturer* will deal with the *end client* at the point of sale or subsequently, such as when complaints arise, claims are made or the *financial instrument* reaches maturity.
- 3.3.12** **G** The target market identified by *distributors* for each *financial instrument* should be identified at a sufficiently granular level.
- 3.3.13** **G** Where a *distributor* is part of a distribution chain, the information referred to in **■** PROD 3.3.10R(2) should include information on the intended *end client*.
- 3.3.14** **R** Where a *firm* acts both as a *manufacturer* and a *distributor*, only one target market assessment is required.
[Note: article 10(2) of the *MiFID Delegated Directive*]
- 3.3.15** **R**
- (1) *Distributors* must have in place adequate product governance arrangements to ensure that:
 - (a) the *financial instruments* and *investment services* they intend to *distribute* are compatible with the needs, characteristics and objectives of the identified target market; and
 - (b) the intended *distribution* strategy is consistent with the identified target market.
 - (2) *Distributors* must appropriately identify and assess the circumstances and needs of the *clients* they intend to focus on to ensure that their

clients' interests are not compromised as a result of commercial or funding pressures.

(3) *Distributors* must identify any groups of *end clients* for whose needs, characteristics and objectives the *financial instrument* or *investment service* is not compatible.

[Note: article 10(2) of the *MiFID Delegated Directive*]

3.3.16 **R** *Distributors* must periodically review their product governance arrangements under ■ PROD 3.3.15R and must take appropriate actions where necessary to ensure they remain robust and fit for their purpose.

[Note: article 16(3) of *MiFID* and article 10(4) of the *MiFID Delegated Directive*]

3.3.17 **G** In the design of *investment services*, to help *clients* make an informed investment decision, *firms* should consider the support *clients* need before they reach the product selection part of the process.

3.3.18 **R** *Distributors* must have in place procedures and measures to ensure that when deciding the range of *financial instruments* and *investment services* to be *distributed*, and the target market, all applicable *rules* are complied with, including but not limited to:

- (1) disclosure (see ■ COBS 4 and ■ COBS 14.3A);
- (2) suitability (see ■ COBS 9A);
- (3) appropriateness (see ■ COBS 10A);
- (4) inducements (see ■ COBS 2.3A); and
- (5) conflicts of interest (see ■ SYSC 10.1).

3.3.19 **G** *Distributors* should take particular care to ensure compliance with ■ PROD 3.3.18R when they intend to *distribute* new *financial instruments* or there are variations to the *investment services* they provide.

[Note: article 10(3) of the *MiFID Delegated Directive*]

Oversight and training requirements

3.3.20 **R** The development and periodic review of product governance arrangements must be monitored by the *person* allocated the *compliance oversight function* of a *firm* in order to detect any risk of failure by the *distributor* to comply with applicable provisions of *PROD*.

[Note: article 10(6) of the *MiFID Delegated Directive*]

3.3.21 **R** The *management body* of a *distributor* must have effective control over the *firm's* product governance process to determine:

3.3.21	R	<p>(1) the range of <i>financial instruments</i> the <i>firm</i> offers or recommends; and</p> <p>(2) the <i>investment services</i> provided to the respective target markets.</p> <p>[Note: article 10(8) of the <i>MiFID Delegated Directive</i>]</p>
3.3.22	R	<p>All relevant staff must possess the necessary expertise to understand:</p> <p>(1) the characteristics and risks of the <i>financial instruments</i> that the <i>firm</i> intends to <i>distribute</i>;</p> <p>(2) the <i>investment services</i> provided by the <i>firm</i>; and</p> <p>(3) the needs, characteristics and objectives of the identified target market.</p> <p>[Note: article 10(7) of the <i>MiFID Delegated Directive</i>]</p>
3.3.23	G	<p><i>Firms</i> should have regard to SYSC 5.1, and in particular SYSC 5.1.5AB R, when considering whether their relevant staff have the necessary expertise.</p>
Compliance reports		
3.3.24	R	<p>Compliance reports to the <i>management body</i> must include information about the <i>financial instruments distributed</i> by the <i>firm</i> and the <i>investment services</i> provided.</p>
3.3.25	R	<p>A <i>distributor</i> shall make the compliance reports available to the <i>FCA</i> on request.</p> <p>[Note: article 10(8) of the <i>MiFID Delegated Directive</i>]</p>
Post-sale review		
3.3.26	R	<p><i>Distributors</i> must regularly review the <i>financial instruments</i> they <i>distribute</i> and the <i>investment services</i> they provide, taking into account any event that could materially affect the potential risk to the identified target market.</p>
3.3.27	R	<p>In carrying out the review in PROD 3.3.26R, <i>distributors</i> must assess at least:</p> <p>(1) whether the <i>financial instrument</i> or <i>investment service</i> remains consistent with the needs, characteristics and objectives of the identified target market; and</p> <p>(2) whether the intended <i>distribution</i> strategy remains appropriate.</p>
3.3.28	R	<p>If a <i>distributor</i> becomes aware that it has wrongly identified the target market for a specific <i>financial instrument</i> or <i>investment service</i>, or the <i>financial instrument</i> or <i>investment service</i> no longer meets the circumstances of the identified target market, it must take appropriate steps, including at least:</p>

- (1) reconsidering the target market; and/or
- (2) updating its product governance arrangements.

3.3.29 **G** A *distributor* may need to take action under ■ PROD 3.3.28R in circumstances where the *financial instrument* becomes very illiquid or very volatile due to market changes.

[Note: article 16(3) of *MiFID* and article 10(5) of the *MiFID Delegated Directive*]

Information sharing

3.3.30 **R** To support the reviews carried out by *manufacturers* under ■ PROD 3.2.19R to ■ PROD 3.2.26R, a *distributor* must provide to the *manufacturer* of each *financial instrument* it distributes:

- (1) information on sales; and
- (2) where appropriate, information on the reviews carried out under ■ PROD 3.3.26R to ■ PROD 3.3.28R.

3.3.31 **G** (1) Information on sales should include information on any sales made outside the target market.

(2) In complying with ■ PROD 3.3.30R it is not necessary to report every sale to the *manufacturer*. *Distributors* should provide the data necessary for the *manufacturer* to review the *financial instrument* and check that it remains consistent with the needs, characteristics and objectives of the target market defined by the *manufacturer*. Relevant information could include:

- (a) summary information of the types of *clients*;
- (b) a summary of complaints received; and
- (c) responses from *clients* to questions suggested by the *manufacturer* for the purposes of obtaining feedback from a *client* sample.

- (3) In determining when providing information on the reviews carried out under ■ PROD 3.3.26R to ■ PROD 3.3.28R is appropriate, a *distributor* should have regard to the requirements on the *manufacturer* in ■ PROD 3.2. Information on the reviews should be shared if the *manufacturer* requests it.

[Note: article 10(9) of and recital 20 to the *MiFID Delegated Directive*]

Responsibilities in chains of distributors

3.3.32 **R** (1) A *firm* which distributes *financial instruments* or *investment services* to *end clients* is responsible for ensuring that the obligations in this chapter are met in respect of any *financial instrument* or *investment service* it distributes to an *end client*.

(2) A *firm* which distributes *financial instruments* to *clients* which are not *end clients* must, in addition to complying with the rules in this

chapter, consider if they are also undertaking a *manufacturing* role and, if they are, also apply ■ PROD 3.2.

3.3.33

R

A distributor which distributes financial instruments to other distributors must:

- (1) ensure that relevant product information is passed from the *manufacturer* to the final *distributor* in the chain; and
- (2) if the *manufacturer* requires information on product sales in order to comply with its obligations under ■ PROD 3.2, enable them to obtain it.

[Note: article 10(10) of the *MiFID Delegated Directive*]