Chapter 3

Product governance: MiFID

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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.

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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.

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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*]