Measuring your approach
MiFID II Paper: Product Governance and Distributor Governance Rules
Welcome to Paper 3 in the Eversheds Sutherland MiFID II Implementation series.

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Background

The FCA is proposing to introduce a new Product Intervention and Product Governance sourcebook (“PROD”) to implement the MiFID II product governance requirements. This will sit alongside the ESMA Guidelines on Product Governance which are currently in consultation.

The purpose of PROD is to improve firms’ product oversight and governance processes (the systems and controls firms have in place to design, approve, market and manage products throughout the products’ lifecycle to ensure that they meet legal and regulatory requirements) and to set out FCA’s statement of policy on making temporary product intervention rules.

Guidance in the current draft of PROD, as set out in the FCA’s third MiFID II implementation Consultation Paper, CP 16/29, states that good governance should result in products that:

– meet the needs of one or more identifiable target markets
– are sold to clients in the target markets by appropriate distribution channels
– deliver appropriate client outcomes

The MiFID II product governance rules in PROD will apply to MiFID investment firms and CRD credit institutions with respect to:

– manufacturing financial instruments and structured deposits
– distributing financial instruments, structured deposits and investment services

A manufacturer is a firm which creates, issues and/or designs investments, including when advising corporate issuers on the launch of new investments. A distributor is a firm which offers, recommends or sells investments or provides investment services to clients.

Other firms which manufacture or distribute financial instruments or structured deposits will be required to take account of the PROD product governance rules as if they were guidance.

The draft ESMA Guidelines on Product Governance include, inter alia, the six categories that firms should use when identifying the target market for a particular financial instrument, structured deposit or investment service and include:

– the type of client to whom the product is targeted
– knowledge and experience
– financial situation with a focus on the ability to bear losses
– risk tolerance and compatibility of the risk/reward profile of the product with the target market
– clients’ objectives
– clients’ needs

Annex 4 of the ESMA Guidelines on Product Governance include illustrative examples and case studies related to the application of certain aspects of the guidelines.

Firms will also need to consider whether the product is complex or non-complex. We expect to will issue a separate paper on this topic as part of our MiFID II series.
MiFID II requirements

All MiFID firms must:

- establish procedures to assess the target market and risks for new products (or product re issues) that the firm manufactures or distributes
- ensure Board level accountability for the process
- employ staff with relevant competence for the relevant roles
- choose appropriate distribution channels
- monitor existing products on an ongoing basis to check they function as expected; are sold to the expected target market and remain consistent with the needs of the target market
- take action if problems are identified

MiFID firms involved in the manufacture of products must also:

- design products that meet the needs of the target market
- stress test the products
- assess whether the charging structure is appropriate
- provide relevant information to distributors

Under MiFID II distributors must also:

- gather relevant information from manufacturers
- provide information to manufacturers to help in the manufacturer’s regular product reviews
- work together when several distributors are involved in the sale of a product

A summary of the above rules are contained within Appendix A
Changes to RPPD rules

The MiFID II rules go beyond the FCA’s existing product governance guidance (contained in the Responsibilities of Providers and Distributors for the Fair Treatment of Consumers (“RPPD”)) in a number of ways as summarised below.

For firms involved in the manufacture of products:

- product design, including product charges, should meet the needs of the target market and the firm should identify groups for whom the product is unlikely to be suitable
- firms should consider the impact of new products on the orderly functioning of the market
- the distribution strategy should meet the needs of the target market
- firms working together to develop a single product should have a written agreement setting out their share of these responsibilities
- the compliance function should monitor product governance and boards must have effective control and oversight over the process

For firms involved in the distribution of products:

- before distributing a product, firms should consider for which target market it is likely to be suitable
- the distribution should meet the needs of the target market
- products should be reviewed regularly to confirm they remain consistent with the target market’s needs and make changes to the distribution strategy or other process if they identify problems
- firms should provide product manufacturers with information on sales and, where appropriate, the regular reviews mentioned above
- the firm’s compliance function should monitor product governance
- Boards should have effective control and oversight over the process
- firms working together to distribute a single product should share information with other firms in the chain
Future FCA Development of PROD

In future the FCA may also consider replacing the RPPD with guidance and rules in PROD for firms who are not subject to the MiFID II requirements.
Preparing to Comply with PROD

MiFID firms and CRD firms distributing financial instruments or structured deposits, who must comply with the rules in PROD, and other FCA firms involved in manufacturing or distributing financial instruments, whom must comply with PROD as if it was guidance should take the following steps before MiFID II comes into force on 3 January 2018:

- ensure that they have procedures in place to assess the target market and risks for new products (or product re-issues) that the firm manufactures or distributes
- establish procedures to ensure Board level accountability for the product oversight and product governance process
- for manufacturers, review processes for distributor due diligence so as to choose appropriate distribution channels
- for manufacturers establish procedures to provide relevant information to distributors
- for manufacturers prepare agreements under which firms working together to develop a single product set out their respective shares of the product governance responsibilities
- for distributors, establish procedures to provide information to manufacturers to help in the manufacturer’s regular product reviews
- for distributors establish protocols to work together when several distributors are involved in the sale of a product

Distribution agreements will need to be amended to comply with PROD requirements as well as other MiFID II changes in areas such as suitability, appropriateness, commission payments and client categorisation.

Firms who have entered into large volumes of distribution agreements will need to consider how to update these in the time available, for example whether one way agreements can be used to update existing agreements. Firms will also need to have arrangements in place to deal with draft agreements and one way agreements that they receive.

The following illustration illustrates the multiple relationships that will need to be considered when complying with PROD:
Appendix A –
Summary of Rules and Guidance in PROD 3

Manufacturers

<table>
<thead>
<tr>
<th>Area</th>
<th>A brief summary of the obligations for manufacturers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product Governance arrangements</td>
<td>- An approval process for new and significant adaptations to financial instruments</td>
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<tr>
<td></td>
<td>- The approval process must include reference to the target market, risk assessment and distribution strategy</td>
</tr>
<tr>
<td>Manufacture by more than one firm</td>
<td>- Where firms collaborate their mutual responsibilities must be outlined within a written agreement</td>
</tr>
<tr>
<td>Target Market</td>
<td>- Each financial instrument must have an identified target market</td>
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<td></td>
<td>- The level of granularity of the target market definition should be proportionate to the nature of the financial instrument and distribution strategy</td>
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<tr>
<td></td>
<td>- An assessment as to whether the risk/reward profile of the financial instrument is consistent with the target market and the business model is driven by good client outcomes</td>
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<tr>
<td>Product testing</td>
<td>- Conducting scenario analysis to assess the risks of poor outcomes</td>
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<tr>
<td></td>
<td>- The scenario analysis should take into account various prescribed factors which includes stress testing and reliability of data/assumptions</td>
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<tr>
<td></td>
<td>- The compatibility of the costs and charges of the financial instrument should also be assessed against the target market, the return expectations and transparency of the charges</td>
</tr>
<tr>
<td>Distribution strategy and information disclosure to distributors</td>
<td>- The distribution strategy should be designed to favour the sale of each financial instrument to the target market</td>
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<td></td>
<td>- The manufacturer must make certain pieces of information available to the distributor. This includes information on the financial instrument, the product approval process, details of the target market assessment and the appropriate distribution channels</td>
</tr>
<tr>
<td>Review</td>
<td>- There are various detailed obligations which explain when a review should occur and what should be assessed</td>
</tr>
<tr>
<td>Conflicts of interest</td>
<td>- Manufacturers must have appropriate procedures to ensure conflicts of interests are mitigated</td>
</tr>
<tr>
<td>Oversight and training</td>
<td>- Management bodies must have effective control over their product governance processes and should be overseen by the compliance oversight function</td>
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<tr>
<td></td>
<td>- 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 manufacturer</td>
</tr>
<tr>
<td>Compliance reports</td>
<td>- Compliance reports must be presented to the management body and include information on the financial instruments that the firm has manufacturer, including information on the distribution strategy</td>
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## Distributors

<table>
<thead>
<tr>
<th>Area</th>
<th>A brief summary of the obligations for manufacturers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Obtaining information from manufacturers</td>
<td>- Sufficient information must be obtained to gain the necessary understanding and knowledge of the financial instrument. The distributor will need to consider various factors to ensure that the information is indeed sufficient and will need to consider proportionality</td>
</tr>
<tr>
<td>Target market and distribution strategy</td>
<td>- The target market must be determined by the distributor using the information obtained from the manufacturer and their knowledge of their own clients</td>
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<td></td>
<td>- When determining a distribution strategy the firm will need to consider various factors including the client's needs and risk appetite, impact of charges on the end clients, financial strength of the manufacturer and how the manufacturer will deal with post sale complaints or claims</td>
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<tr>
<td></td>
<td>- Distributors should have in place adequate arrangements to ensure that the distribution strategy is consistent with the target market</td>
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<tr>
<td>Oversight and training</td>
<td>- See table left, similar obligations to manufacturers but with reference to the distribution process and not product manufacturing</td>
</tr>
<tr>
<td>Compliance reports</td>
<td>- See table left, similar obligations to manufacturers but with reference to the distribution process and not product manufacturing</td>
</tr>
<tr>
<td>Post-sale review</td>
<td>- There should be a post-sale review process which at least assesses whether the product is still consistent with the target market and if the distribution strategy remains appropriate. The distributor should take appropriate actions following this review.</td>
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<tr>
<td>Information sharing</td>
<td>- The distributor must provide to the manufacturer informal on sale and the post-sale reviews carried out</td>
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<td>- The sale data provided should include those items that are necessary for the manufacturer to check consistency with the needs, characteristics and objectives of the target market. This should include information on the types of clients, complaints received and any feedback received from clients</td>
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<td>Chains of distributors</td>
<td>- Manufacturers must have appropriate procedures to ensure conflicts of interests are mitigated</td>
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