

# Impact of the MiFID II Product Governance Rules

## Overview and background

One of the EU's most ambitious regulatory reforms that took effect from 3 January 2018 imposes a series of new requirements on investment services providers and manufacturers of financial instruments in the EU. Under the Markets in Financial Instruments Directive (**MiFID II**) a new product governance regime was introduced which sets out a high-level framework for manufacturers and distributors of financial instruments.

Since its implementation in November 2007, MiFID I has been the cornerstone of capital markets regulation in Europe. However, since its inception, not all benefits have been fed down to the end investor as envisaged. Thus, MiFID II, aiming to address the shortcomings of the original MiFID release, has been enacted with the objective of enhancing the level of investor protection by the way of requiring investment firms subject to MiFID II to take responsibility during all stages of the product lifecycle process, that products and related services are offered in the interest of end clients.

## Product governance rules

One key area is the new product governance regime which has been enacted with the objective of ensuring that firms act in the best interests of their clients during all stages of the product lifecycle process. Areas which have caused much contention within the legislation are the definition of “target market”, the new expansive obligations of the manufacturer and distributor, firms' obligation to disclose information about their product cycle process and how firms prevent conflicts of interests from adversely affecting their clients.

The new product governance rules, as laid down in Articles 16(3) and 24(2) of MiFID II as well as in Article 9 and 10 of the MiFID II Delegated Directive 2017/593, cover a broad range of topics, especially in

terms of the development and placement of products. The guidelines are designed to act as a tool so firms can clearly and efficiently define, review and share target market information that is broadly in line with a common industry approach.

MiFID II commands incremental changes on EEA investment firms (**MiFID Firms**) when they manufacture and/or distribute financial instruments and structured deposits. Financial instruments include, but are not limited to, bonds, shares and derivative instruments. The product governance rules are only applicable to MiFID Firms; however, non-MiFID Firms are indirectly impacted (given that e.g. where a non-MiFID Firm manufactures a bond issue which includes sales in the EEA, the MiFID Firm needs to ensure that it obtains sufficient information about the bonds and the target market of such bonds from the non-MiFID Firm).

Key components to this framework are the obligation of robust processes for the design of financial products and services, the identification of target investors and the ongoing monitoring of distribution activities.

To ensure compliance with MiFID II obligations, MiFID Firms are required to take steps to identify at a sufficiently granular level a potential target market of investors for manufactured products and furthermore to ensure that the strategy for distribution of the financial instruments is compatible with the identified target market.

## Scope of the MiFID II Framework

The MiFID II Delegated Directive separates MiFID Firms into two categories: manufacturers and distributors. The product governance rules apply to MiFID Firms when they create, develop, issue and/or design financial instruments or advise corporate issuers on the launch of new financial

instruments (manufacturers). Manufacturers must undergo a product approval process and governance arrangements which address conflicts of interest, market integrity and potential threats to the underlying functioning and stability of financial markets. The performance of products should be subject to period review.

Distributors are defined as investment firms that offer or recommend financial instruments to clients; MiFID Firms that are joint lead managers in a bond issue are most likely both manufacturers and distributors (and therefore must comply with the requirements for both categories, although they may do this using a single process rather than duplicating their procedures) and any other MiFID Firms in the syndicate of underwriters offering or recommending the bonds are distributors for this purpose. Distributors determine the actual target market by either adopting the manufacturer's target market or refining it; hence, products are distributed to the proper market. They also have product governance controls in place to ensure that products and services they offer or recommend are compatible with the needs, characteristics and objectives of the identified target market. Moreover, they must comply with the regular MiFID disclosure and the suitability/appropriateness assessment.

Manufacturers need to take reasonable steps to provide distributors of instruments with appropriate information on the investment product and the product approval process, including necessary information on the identified target market and appropriate channels for distribution. In addition, as from 3 January 2018 co-manufacturers are required pursuant to Art. 9.8. of the MiFID II Delegated Directive to outline their mutual responsibilities in a written agreement. Therefore, MiFID Firms now usually include respective language in subscription agreements they enter into.

MiFID Firms are further required to comply with the product governance rules in an “appropriate and proportionate” way, by considering the nature of the investment product, the investment service and the target market of the product.

### Product approval and other requirements

MiFID Firm manufacturers (and MiFID Firm distributors where a target market is not defined by the manufacturer) must have an approval process in place to identify the target market for a financial instrument and specify the type of client for whose needs, characteristics and objectives the financial instrument is compatible. The European Securities Markets Authority (**ESMA**) provides in its “Guidelines on MiFID II product governance requirements” that MiFID Firm manufacturers should use the following list of five categories when considering the potential target market for a financial instrument:

- a) type of clients to whom the financial instrument is targeted (e.g. “retail client”, “professional client”). knowledge about relevant elements (e.g. product type) and experience of clients in thematically related areas;
- b) financial situation in terms of the ability to bear losses;
- c) risk tolerance and compatibility of the risk/reward profile of the financial instrument with the target market; and
- d) client's objectives and needs.

In addition to the target market assessment, MiFID Firm manufacturers must determine a distribution strategy which is consistent with the identified target market, including appropriate distribution channels.

Furthermore, manufacturers must review financial instruments on a regular basis, considering any event that could materially affect the potential risk to the identified target market, taking appropriate action including notifications of any changes to distributors or stopping further issuance of products. The management body must have effective control over the product governance process, relying on a compliance function to monitor the development and period review of product governance arrangements.

### Outlook and final thoughts

MiFID Firms face crucial practical and logical challenges in complying with MiFID II. In particular, it will be difficult for MiFID Firms to execute wide-ranging target market review procedures, given the traditional bond market practice whereby issuers engage and remunerate underwriters for the initial issuance procedure only and bonds are typically traded in the secondary market by entities with no connection to the manufacturer.

In practice also the conclusion of the so called “co-manufacturing agreements” for syndicated bonds as well as securitization transactions has proven to be difficult as the way of communicating the target market differs across the EU Member States. We can only hope that after the first month after the entry in force and intensive discussions among market participants, market standards get established and the new products governance regime really helps to improve investor protection without disrupting issuance processes.

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