Key Points

- Firms that manufacture and/or distribute financial instruments must have arrangements in place for product governance.

- Product manufacturers must have a product approval process. The target market and performance of products should be subject to periodic review.

- Firms that offer or recommend financial instruments must ensure that their products meet the needs of the relevant client market. Distributors must ensure that products are distributed to the proper market and carry out periodic reviews to ensure that this remains the case.

- ESMA, the European Banking Authority ("EBA") and national competent authorities ("NCAs") have powers under MiFID II to prohibit or restrict the marketing, distribution or sale of financial instruments, or particular financial activities or practices.

- ESMA has produced detailed criteria to determine when the supervisory authorities and regulators may intervene to ban or restrict certain financial products, services or activities.
Product governance

MiFID I sets out a high-level framework for investment firms' organisational requirements. At present, firms are required to:

- establish policies and procedures sufficient to ensure compliance with their MiFID obligations as well as appropriate rules for personal account dealing; and
- have effective arrangements to prevent conflicts of interest from adversely affecting the interests of their clients.

However, the Commission's MiFID consultation review in December 2010 identified a need for more specific requirements to protect investors. In particular, the Commission proposed that firms should be required to have appropriate policies and controls to ensure that product design and sale and distribution would not be detrimental to clients' interests. The consultation suggested the following modifications to the MiFID Implementing Directive:

- Firms would be required to run an assessment of the compatibility of a product, service or operation with its intended client base.
- The requirement on the compliance function to ensure that the product, service or operation complied with all applicable rules would be strengthened.
- Firms would have to manage adequately the risks relating to any new product, service or operation.
- Firms would have to stress test their products and services as appropriate.
- Firms should periodically review the distribution and performance of products and services.
- Firms should ensure staff have the necessary expertise in relation to the products and service, and receive appropriate training on new products.
- The board should have effective control over this area, with appropriate information supplied to it by the compliance function on request.¹

Governance requirements for manufacturers and distributors

Following the MiFID I review, MiFID II now includes specific requirements relating to the manufacture and distribution of financial instruments. In line with the obligation to act in the best interests of their clients and comply with their MiFID obligations, investment firms should:

- understand the features of financial instruments that they offer or recommend;
- establish and review policies and arrangements to identify the category of clients targeted;
- ensure that any products which they manufacture:
  - meet the needs of identified target markets of end clients;
  - take reasonable steps to ensure that the products are distributed to this target market; and
  - periodically review the identification of target market and the performance of products; and
- ensure that, in relation to any products which they offer or recommend (but have not manufactured), they obtain relevant information on the product approval process.²

MiFID II requires firms to take all reasonable steps to prevent conflicts of interest from adversely affecting their clients. In terms of product governance, this requires firms manufacture financial instruments to:

- operate and review a product approval process for new financial instruments and for significant

¹ European Commission, Public consultation: Review of the Markets in Financial Instruments Directive (MiFID), 8 December 2010, paragraph 7.3.3
² MiFID II Directive, recital 71
adaptations of existing instruments. This product approval process must specify an identified target market of clients and ensure that relevant risks to this target market are assessed, and that the intended distribution strategy remains appropriate;

- make appropriate information on the financial instrument and the product approval process available to distributors.\(^3\)

According to the MiFID II rules on investor protection, a firm that manufactures financial instruments for sale to clients must ensure that:

- the financial instruments are designed to meet the needs of an identified target market of end clients;
- the strategy for distribution of the financial instruments is compatible with the target market; and
- it takes reasonable steps to ensure that the financial instrument is distributed to that target market.\(^4\)

In addition, a firm that offers or recommends a financial instrument must:

- assess the compatibility of the financial instrument with the needs of its clients; and
- ensure that the instruments are only offered or recommended when this is in the clients’ interests.\(^5\)

**ESMA advice on product governance**

ESMA has stated this will affect firms in the following categories:

- firms that create, develop and design products and offer them directly to clients (i.e. as manufacturer and distributor);
- firms that develop products and offer them to clients through other firms (manufacturers); and
- firms that offer clients products manufactured by third parties or other investment firms (distributors).

ESMA has noted that if a firm is both a manufacturer and distributor, it must comply with the requirements for both categories, although it may do this using a single process rather than duplicating its procedures.\(^6\)

**Product manufacturers**

In relation to product manufacturers, ESMA has proposed that firms should:

- ensure that conflicts of interest are managed between the firm and its clients;
- ensure oversight and control;
- assess the potential target market;
- assess the risks of poor investor outcomes;
- consider the charging structure;
- provide adequate information to distributors; and
- regularly review the products.

ESMA has considered the options for the frequency of product reviews, and whether this should be a positive duty on firms to check that the product functions. ESMA proposes that, depending on the complexity of the product, the products should be reviewed at the following stages:

- prior to any relaunch or further issue;
- when aware of event that could materially affect the potential risk to investors; and

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\(^3\) MiFID II Directive, article 16(3).

\(^4\) MiFID II Directive, article 24(2).

\(^5\) MiFID II Directive, article 24(2).

\(^6\) ESMA, Consultation Paper, 22 May 2014, chapter 2.7.
Product distributors

ESMA has proposed that distributors should be required to:

- have product governance processes to ensure that their products and services match the intended target market;
- periodically review their product governance arrangements;
- provide sales information to manufacturers to assist them with their post-sales governance requirements;
- involve the compliance function in the product governance arrangements;
- ensure that the management body of the firm endorses the range of the products and services and their respective target markets; and
- (where products are manufactured or issued by firms outside Europe or by non-MiFID firms) take reasonable steps to ensure that the information obtained from the manufacturer/issuer is adequate.

ESMA has noted that in some circumstances, different firms may work together to distribute a product. According to ESMA, the firm with the client-facing relationship will have ultimate responsibility for meeting the product governance obligations. However, other firms in the chain will have responsibilities to pass on information to the client-facing distributor and to the manufacturer, and to apply the governance requirements applicable to manufacturers, where applicable.

Product intervention

Articles 40 to 43 of the Markets in Financial Instruments Regulation ("MiFIR") permit regulators to ban or restrict the marketing, distribution or sale of certain financial products, or to intervene in relation to certain financial activities.

MiFIR sets out the conditions when ESMA, the EBA or NCAs may intervene in this way. These are detailed in MiFIR but broadly include:

- the existence of a significant investor protection concern, a threat to the orderly functioning and integrity of financial markets or commodity markets, or a threat to the stability of the whole or part of the financial system in the EU;
- the absence of EU regulatory requirements to address the threat; and
- (in the case of ESMA and the EBA) the failure by NCAs adequately to address the threat.

There are limits on the ability of the regulators to intervene in the market. For example, among other restrictions, any intervention should not:

- have a detrimental effect on market efficiency of financial markets or on investors that is disproportionate to the benefits of the action; or
- create a risk of regulatory arbitrage.

ESMA advice on product intervention

ESMA is required to propose criteria and factors to be taken into account by ESMA, the EBA and NCAs in determining when there is a significant investor protection concern, a threat to the orderly functioning and integrity of the markets or a threat to the stability of the financial system. These criteria and factors include:

- the degree of complexity of a financial instrument or structured deposit and the relation to the type of client to whom it is marketed, distributed and sold;

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8 ESMA, Consultation Paper, 22 May 2014, pp. 44-45, 48-50; ESMA, Technical Advice, pp. 59-61
9 ESMA, Consultation Paper, 22 May 2014, pp. 45 and 50; ESMA, Technical Advice, pp. 59-61.
10 Articles 40 and 41, MiFID II Directive.
• the degree of innovation of a financial instrument or structured deposit, an activity or a practice;

• the leverage a financial instrument or structured deposit or practice provides; and

• (in relation to the orderly functioning and integrity of financial markets or commodity markets) the size or the notional value of an issuance of financial instruments or structured deposits.\(^\text{11}\)

**Timescales for implementation**

The MiFID II Directive and MiFIR came into force on 3 July 2014, and most of their provisions will come into effect in member states from 3 January 2017. Member states have until July 2016 to transpose the MiFID II Directive into national law.

However, following discussions between ESMA and the European Commission, it is now expected that the implementation of MiFID II will be delayed until January 2018. The European Commission is also drafting delegated acts on the basis of the Technical Advice received from ESMA in December 2014.

\(^{11}\text{ESMA, Consultation Paper, 22 May 2014, chapter 2.24; ESMA, Technical Advice, 19 December 2014, chapter 2.24.}\)
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