MiFID II Product Governance

Proportionality: Rules of the road

Nicola Higgs

LATHAM & WATKINS

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The product governance rules in MiFID II represent a fundamental change in the way firms design and distribute financial instruments. The rules largely replicate the existing UK regime applicable to retail structured products. However, in extending the rules to all financial instruments, the regulators have done nothing to tailor them to financial instruments that may be vastly different in terms of risk profile or complexity. Nor have they been express in confirming how the rules might apply in wholesale markets. Instead, the regulators have introduced the concept of proportionality and have left it up to individual firms to define how proportionality should be applied in the context of their business.

Defining proportionality under the MiFID II product governance regime is undoubtedly one of the key challenges for firms facing implementation projects. In this briefing we set out some rules of the road when determining how proportionality applies and illustrate how firms can use these to develop practical implementation solutions.

If proportionality is intended to limit the scope of certain rules to particular financial instruments/services, it is important to bear in mind the basic principles that apply regardless of the application of proportionality.

PART I: FUNDAMENTAL PRINCIPLES

When considering proportionality, it is important to comply at all times with the following fundamental principles of product governance:

Principle 1: Identify the end investor

1.1 A fundamental principle of product governance is the obligation to look beyond your immediate counterparty when determining whether a product is ultimately manufactured for, or distributed to, an eligible counterparty, professional investor, or retail investor.

Principle 2: Adopt a purposive implementation approach

2.1 The MiFID II product governance rules are high level and non-prescriptive as regards how they apply to different products, services and/or client types. It is therefore up to the firms to determine how to comply with the rules in a way that is appropriate and proportionate in light of the role they are playing in the product/service lifecycle, the nature of the counterparty, and complexity of the financial instrument.

2.2 In determining proportionality, firms should be mindful of the purpose of the product governance regime and design a compliance framework that achieves its objectives, namely:

(a) manufacturers of products should share responsibility with distributors for the distribution of financial products;

(b) firms must reduce (or ideally avoid) potential risks of investor detriment from an early stage in a product's lifecycle; and

(c) an investor's experience should not be affected by whether a product or service was provided and distributed by a single institution or by two or more institutions.

Principle 3: All rules apply to all (in scope) products/services

3.1 Once you have determined that an investment product or service is a MiFID II product, proportionality does not mean that you can disapply some or all of the rules.[1] Rather, the proportionate application of product governance rules means there is some flexibility in the manner by which firms meet their obligations.

3.2 In performing this analysis you may determine that an obligation is already met via compliance with a different regulatory regime so there is nothing to do per se. Rather, you may simply need to link the product governance principles within an existing established policy.

[1] Firms must remember that since the majority of product governance obligations are prescribed by the MiFID II Level I text, local member state regulators and firms do not have the power to declare that certain rules are disapplied for certain financial instruments.

3.3 Further, you may decide that compliance is impossible in the context of the product or service in question. If you do, keep a note of your reasoning, but do not use language such as "*it does not apply*".

3.4 The mantra for firms implementing MiFID II product governance should be: if the rule does not match the product, what else can be done consciously to manage risk to the investor protection objective?

Principle 4: Foster cooperation between manufacturers and distributors

4.1 Where both manufacturers and distributors interact in a product's lifecycle, it is essential that this interaction is open and collaborative if either firm is to comply with the expectations of the regulator.

4.2 Manufacturing firms will be under pressure to only continue to use distribution channels which demonstrate a willingness to openly share information. Likewise, distributors should only continue to distribute the products of a particular manufacturer where they are receiving sufficient information to enable them adequately to understand the risk of doing so.

Principle 5: Record & review decisions

5.1 Any decisions taken in relation to proportionality must be properly justified and comprehensively documented.

5.2 Any conclusions reached during MiFID II implementation projects in 2017 will need to be revisited and reconsidered on an appropriate periodic basis going forward.

PART II: PROPORTIONALITY RULE BOOK

Each category of financial instrument and/or service should be assessed against the following rule book to assess how proportionality might apply:

Rule 1: **Identifying the investor**	Activities fall within scope of product governance where: • an investment firm manufactures financial instruments for sale to **clients**; or • an investment firm offers or recommends financial instruments (which it does not manufacture) to **clients**. In each case 'client' should be construed as 'investor' (i.e. a firm does not need a client relationship with an investor in order for the product governance rules to be triggered). In the case of a bilateral trade between two counterparties, with no onwards distribution to a client, the selling counterparty will be a manufacturer. However, the purchasing counterparty should not be categorised as a distributor since there is no onwards distribution.
	Q. 1: Is the trade bilateral between two counterparties with no onwards distribution to an investor?
Rule 2: **Number of investors**	ESMA's draft guidelines confirm that for bespoke or tailor-made products, the target market of the product will usually be the client who ordered the product, unless the distribution of the product to other clients is also foreseen. Where the target market only consists of a particular client, a number of the follow-on obligations for manufacturers fall away. For example, the following would not be required: **A. Product governance arrangements**: • obligation to assess target market or end clients (as the target market that must be specified will be the client who has ordered the product) • obligation to ensure that the intended distribution strategy is compatible with the identified target market (although controls must be in place to prevent the onward distribution of the product without further product governance assessment) **B. Post-sale review in relation to:** • whether the product ended up in the hands of the correct target market • whether the financial instrument is reaching clients for whose needs, characteristics and objectives it is suitable Further, there should be no obligation on the distributor to collect management information to illustrate the above.
	Q. 2: Is the product bespoke for one investor or intended for multiple investors?
Rule 3: **End investor categorisation**	Clients are categorised under MiFID II as retail; elective professional; per se professional and eligible counterparty. The MiFID II client categorisation framework calibrates conduct of business protections to the needs of each client category. A practical way to approach proportionality is to adopt a different framework depending on the client category. In a **wholesale market** context, MiFID II allows certain assumptions to be made about a client's knowledge and experience with respect to understanding investment risks. Further, MiFID II recognises **eligible counterparties** as the most sophisticated class of investors and capital markets participants, consequently switching off many of the conduct of business protections in respect of these clients.[2] For example, Article 24(2) of MiFID II, which requires manufacturers to ensure that financial instruments are designed to meet the needs of the identified target market and that the distribution strategy is appropriate, and contains the post-sale obligation of ensuring a product ends up in the hands of the correct target market, is switched off for eligible counterparty clients. MiFID II does also however seek to extend certain information and reporting requirements when dealing with eligible counterparties (e.g. information about investment products and costs and charges). (See Proportionality Case Study 1 at Part III below).
	Q. 3: Is the product intended for: retail; elective professional; per se professional; or eligible counterparty clients?

[2] Although it should be noted that the "core" product governance requirements at Article 16(3) of MiFID II apply irrespective of client type.

<table>
<tr><td rowspan="2">Rule 4:
Is there a co-manufacturer?</td><td>A manufacturer may agree in writing with a co-manufacturer that the co-manufacturer will be responsible for certain of the manufacturer product governance responsibilities. Manufacturers should not assume they can assign the entire obligation under a specific rule, other than in the case of defining a target market, since this only needs to be carried out once. However, once a manufacturer has determined that there is no obligation to undertake a target market assessment, a number of the related product governance obligations fall away.</td></tr>
<tr><td>Q. 4:
• Is the product co-manufactured with another regulated firm?
• Is the co-manufacturer willing to undertake the role of a manufacturer for product governance purposes (e.g. define the target market).</td></tr>
<tr><td rowspan="2">Rule 5:
Complexity & risk</td><td>Understanding the relative complexity and risk of a product is essential to ensuring that a product is distributed to the appropriate target market, and in determining that an appropriate distribution strategy is used.

As a basic principle, complex and/or risky products sold to less sophisticated clients generally will be subject to enhanced product governance controls. For example, more granular target market assessments, enhanced due diligence on distribution channels etc.

Some products may already be subject to a risk rating score (e.g. those falling within the UCITS KIID or PRIIPs KID regime), in which case this existing scoring methodology can be embedded within a firm's product governance processes. In other cases, firms will need to come up with their own scoring methodology as regards how they categorise products as low, medium or high risk/complexity so that this can be embedded within a firm's product governance process and the target market and proportionality can be applied accordingly. For this purpose, characteristics of the product such as the costs and charges structure, risk-reward profile, liquidity, and the innovative character of the product should be considered.</td></tr>
<tr><td>Q. 5: What is the product's risk/complexity score?</td></tr>
<tr><td>Rule 6:
Primary or secondary market</td><td>The MiFID II Delegated Act states: "…in the interests of investor protection, product governance rules should apply to all products sold on primary and secondary markets, irrespective of the type of product or service provided and the requirements applicable at point of sale". However, those rules may be applied in a proportionate manner, depending on the complexity of the product and the degree to which publicly available information can be obtained, taking into account the nature of the instrument/investment service and the target market.

Whether something is sold via a primary or secondary market route has a significant impact on a manufacturer's ability to control further distribution of a product and the number of other overlapping regulatory regimes which might therefore apply to the product, which will need to be taken into account when assessing proportionality.

A. Primary markets

When issuing a product for the first time, a manufacturing firm generally will have complete control of the distribution of that product. Therefore, no proportionality can be assumed based on this feature alone. However, primary markets are closely controlled already, for instance, through prospectus or allocation requirements. These may assist manufacturing firms to meet some of their obligations.

B. Secondary markets

Trading of financial instruments in secondary markets is embedded with characteristics that allow firms to draw certain conclusions as regards how product governance should be applied proportionately in the context of these markets.

Where a relatively liquid financial instrument is traded on a secondary market, the following characteristics pose practical challenges for full scope compliance with the product governance regime:

• Relationships between manufacturers and distributors – Often there will be no direct relationship between manufacturers and distributors. This is because there may be unlimited distributors in the chain, making it impossible to identify the end investor and therefore assign responsibility to the distributor who deals with that investor. In many cases, there may be no such end investor.

• Public offers – Once a security has been approved for public offer in a particular jurisdiction, it is not lawful for a firm to restrict further distribution. The circumstances for secondary market trading are prescribed by law. Target market analysis therefore is likely to be more straightforward.

• Restrictions on systematic internalisers ("SIs")/market makers – MiFID II rules applicable to SIs and market makers require them to quote publicly and therefore to offer for sale financial instruments on a continuous basis. Such firms would be in breach of their regulatory obligations if they refused to trade with a counterparty that met the price quoted. Target market analysis should not be relevant or undertaken.</td></tr>
</table>

	• **Third countries** – There are no restrictions on third country brokers selling into Europe where dealing is conducted in a relevant third country. Therefore, it would seem disproportionate to apply a more stringent regime for EEA-based distributions that might occur on a secondary market. Further, in the case of non-complex instruments traded on secondary markets: • **Appropriateness** – MiFID II appropriateness rules mean that a distributor will not have to assess the appropriateness of a non-complex product when sold to an investor (on its own initiative) on an execution only basis. Many of the limbs of an appropriateness assessment directly overlap with the categories of target market. Therefore, requiring a distributor to collect information on a purchaser in order to assess the target market would run contrary to this provision (see Rule 7 below). Nevertheless, there will be certain instances of secondary market trading where the above fact pattern may not be true. For example: • **Liquidity** – An assessment of the relative liquidity of a product will need to be undertaken, as it will often be the case that more sophisticated products are less liquid and therefore there is greater opportunity to control the target market. There is often a greater (investor protection) need to control distribution of sophisticated products. • **Complex investments** – The challenges of controlling secondary market distributions will always be trumped by the need to demonstrate sound product governance in the case of complex products. Therefore, additional systems and controls may need to be put in place for manufacturers and distributors in the case of such products. • **Private client stockbrokers** – Private client stockbrokers may be categorised as professional clients, however they will often be trading directly as agent for underlying retail investors. Therefore, firms should ensure that their distribution strategies in respect of these counterparties are appropriate in light of the sophistication of the product. • **Block trading** – A block trade is one example where a distributor in a secondary market will have an opportunity to control the distribution of a significant proportion of the products in issue. Therefore, firms should consider implementing the same product governance standards for block trades as for a primary markets book-build process. • **Product lifespan** – The lifespan of a product (i.e. its intended term or how long it remains in issue for) is an important factor in building a proportionate product governance framework. For example, a product such as a listed share, which has in indefinite term, presents certain practical challenges when it comes to controlling secondary market distribution since it is impossible to identify the end investor and therefore, identify the distributor who should be subject to MiFID II product governance requirements by virtue of interfacing with that investor. Therefore, proportionality should be applied in this context to avoid overly onerous obligations on every distributor in the chain. This will not be the case when products are issued with a defined term and where the investor is known, where compliance with the full MiFID II distribution requirements is possible.
	Q. 6: • **Is there a secondary market in the product?** • **What is the nature of the secondary market (i.e. listed and traded product v secondary market limited to the original issuer)** • **Is the product a liquid stock?** • **What barriers to the control of distribution in the secondary market might be present?** • **Are there circumstances where it is possible to control secondary market distribution?** • **Are there complex features embedded within the product which mean the inability to control distribution in the secondary market might pose a risk to investor protection?**
Rule 7: **Lessons from other conduct rules**	Product governance overlaps with a number of other investor protection topics that form part of a MiFID II implementation project. MiFID II provides examples of where these other conduct obligations apply proportionately depending on the sophistication of the client. Firms can learn from the regulator's approach in these areas when designing a proportionate product governance implementation framework. **A. Best execution – appropriateness of costs and charges** Delivering best execution is fundamental to the delivery of good outcomes for investors who rely on regulated firms to act in their best interests. Under the existing UK product governance regime, the FCA confirmed that best execution applies to primary and secondary issuances of structured products. In general, MiFID II is expanding the way regulated firms think about achieving best execution for their clients, across all product lines, particularly in quote-driven markets where no pricing benchmark analysis is possible. This results in firms having to compare the fair value of the product with the **costs and charges** embedded within it, to ensure that any conflicts between the firm and the client are managed appropriately.

Firms currently will be assessing which product lines are subject to the MiFID II best execution obligations and will be concluding that some products are not subject to best execution obligations.

For example, firms are allowed to assume that **professional clients** don't rely on the firm to achieve best execution. However, in order to reach this conclusion, firms must apply a four-fold cumulative test based upon:[3]

- which party initiates the transaction;
- questions of market practice and the existence of a convention to 'shop around';
- the relative levels of price transparency within the market; and
- the information provided by the firm and any agreement reached.

A basic principle of good product governance is ensuring the appropriateness of costs and charges embedded within a product. An analysis of the regulator's approach to best execution allows us to conclude that testing the appropriateness of costs and charges may not be proportionate in a professional market where the above four-fold test is satisfied. We can therefore assume that the appropriateness of costs and charges requires less scrutiny when dealing with professional clients in a product governance context.

Q. 7: Does best execution apply to this product line when dealing with this category of client? If not, an assessment of the appropriateness of costs and charges should not be warranted.

B. Appropriateness/Suitability – target market

MiFID II product governance requires firms to align the product design with the identified characteristics of the target market identified by ESMA[4]

- Client type (i.e. categorisation)
- Knowledge & experience
- Financial situation, with a focus on ability to bear losses
- Risk tolerance and compatibility of the risk/reward profile
- Client's objective
- Client's needs

It also requires firms to identify an appropriate distribution strategy to mitigate the risks of the product ending up in the hands of the wrong target market, taking into account whether that channel is execution only, advised or discretionary managed.

Appropriateness

One of the limbs of a target market assessment – "knowledge and experience" – corresponds to the obligation of a firm to conduct an appropriateness assessment when providing investment services other than investment advice or portfolio management. However, in certain circumstances MiFID II does not require firms to assess appropriateness (or effectively does not require this, by allowing the firm to assume that the client has the necessary level of knowledge and experience), as illustrated by the crosses in the table below. Therefore, a proportionate approach to product governance implementation would be to disapply this limb of a target market assessment under the same circumstances.

Target market categories	Appropriateness assessment				
	Complex product			Non-complex product[5]	
	Retail client	Elective professional	Per se professional	Client initiative	Firm initiative
Knowledge & experience	✓	✗	✗	✗	✓

Q. 8: Do the circumstances allow you to apply proportionality to exclude knowledge and experience from a target market assessment?

3 CESR Q&A on Best Execution under MiFID I.

4 Whilst the current draft ESMA guidance assumes that all six categories of target market must be identified for all financial instruments/services, regardless of the sophistication of the client, there is currently extensive lobbying on this point based on analysis similar to that contained in this note. Therefore, we assume that the ESMA position could change when the finalised guidance is published.

5 Client categorisation not relevant.

Suitability

Firms are required to conduct a suitability assessment when acting in an advisory or discretionary manager capacity. All of the limbs of a target market assessment other than "needs" directly overlap with a suitability assessment. However, in certain circumstances, MiFID II allows firms to disapply certain limbs of a suitability assessment, as illustrated by the crosses in the table below. Therefore, a proportionate approach to product governance implementation would be to disapply the same limbs of a target market assessment under the same circumstances.

Target market categories[6]	**Suitability assessment**		
	Retail	**Elective professional**	**Per se professional**
Knowledge & experience	✓	×	×
Financial situation / ability to bear losses	✓	✓	×
Risk tolerance	✓	✓	×
Objectives	✓	✓	✓

Q. 9: If you are acting in an advisory capacity, does the categorisation of the client mean you can apply proportionality to exclude knowledge and experience, financial situation and risk tolerance from a target market assessment?

[6] Note: "client type" has not been included in the list below since this is relevant to all client relationships, regardless of the capacity in which the distributor acts on an advised / ex only basis.

PART III: PROPORTIONALITY CASE STUDIES

The case studies below are intended to highlight how the proportionality rules explained in Part II might be applied in some practical scenarios.

Case study 1: Wholesale markets

This table provides an example proportionality analysis in the case of a bilateral trade between two eligible counterparties (with no onward distribution). In line with a robust product governance implementation framework, the assumptions in this table need to be confirmed for each different financial instrument in scope of MiFID II product governance.

<table>
<tr><td rowspan="8">Manufacturer obligations</td><td>Product approval</td><td>Firms will have new business arrangements in place before expanding into a new product area. Once a product category has been approved for distribution to eligible counterparties, products within that category should not need to be approved on a product by product basis. This is because products do not need to be tested in line with the target market's needs and wants in the case of eligible counterparty trades.[7]

Manufacturers will remain under an obligation to consider whether the financial instrument represents a threat to the orderly functioning of the market.</td></tr>
<tr><td>Target market</td><td>Target market is the counterparty to the trade.[8,9] Therefore, no obligation to communicate the target market.</td></tr>
<tr><td>Distribution strategy</td><td>No obligation to assess distribution strategy[10]. Therefore, no obligation to communicate the distribution strategy (although there must be measures in place to prevent onward distribution of the product without further product governance assessment).</td></tr>
<tr><td>Product testing</td><td>Product specific analysis needs to be carried out to determine whether stress/scenario testing would be appropriate in the context of the product, taking into account the complexity of the product and the extent to which the product's risk profile and investment proposition was defined by the manufacturer or the client.[11] The need to assess poor outcomes for the client should fall away where an eligible counterparty has determined its own need for a trade.</td></tr>
<tr><td>Charging structure</td><td>No obligation to assess whether the charging structure is compatible with the needs of the target market. However, the charging structure should be made transparent in line with other MiFID II obligations (where applicable).</td></tr>
<tr><td>Conflicts of interest</td><td>Firms will have to consider whether any conflicts associated with the product sold to an eligible counterparty are appropriately managed.</td></tr>
<tr><td>Information to distributors / investors</td><td>Knowledge and experience can be assumed therefore, confirming details of the trade should be sufficient.</td></tr>
<tr><td>Post–sale review</td><td>No review required to ensure the product ended up in the hands of the correct target market, although there must be measures in place to prevent onward distribution of the product without further product governance assessment. Therefore, no obligation to collect management information from distributors.

No obligation to monitor market events and communicate these to the counterparty since it can be assumed the counterparty has systems in place to monitor its exposure to such events in accordance with its regulatory obligations.

However, if problems come to light in relation to products, manufacturers should take this into account when deciding to continue to distribute them.</td></tr>
</table>

[7] Article 30(1) & Article 24(2) MiFID II.
[8] Article 30(1) & Article 24(2) MiFID II.
[9] Para 20 Draft guidelines for MiFID II Product Governance requirements ESMA 2016/1436.
[10] Article 30(1) & Article 24(2) MiFID II.
[11] For reverse enquiry wholesale market trades, with no onwards distribution, it may be prudent for the "manufacturer" to include language in the terms of business to the effect that in the case of bespoke products provided on parameters defined by the client, it is assumed that the client is responsible for having carried out any stress/scenario testing.

	Oversight and training	Oversight and training obligations should result in the limited obligations above being embedded within the business and reviewed on a periodic basis.
	Compliance reports	Compliance reports to the management body should reflect breaches in the limited obligations set out above.

Case study 2: OTC products

OTC derivatives are contracts that are traded (and privately negotiated) directly between two parties, without going through an exchange or other intermediary.

We have outlined below a case study based on a simple interest rate swap. Interest rate swaps provide users with a way of hedging the effects of changing interest rates. For example, a corporate can convert floating-rate interest payments to fixed-rate payments if it thinks interest rates will rise (which would make its liabilities more expensive). Corporates might also use interest rate swaps in conjunction with new debt issuance, raising money on, say, a fixed basis and swapping it into floating-rate debt. In an interest rate swap there is a fixed-rate payer (floating-rate receiver) and a fixed-rate receiver (floating-rate payer).

Q. 1: Is the trade bilateral between two counterparties with no onwards distribution to an investor?	Bi-lateral
Q. 2: Is the product bespoke for one investor or intended for multiple investors?	Bespoke
Q. 3: Is the product intended for: retail; elective professional; per se professional; or eligible counterparty clients?	Professional (corporate)
Q. 5: What is the product's risk/complexity score?	Medium
Q. 6: Is there a secondary market in the product?	N/A
Q. 7: Does best execution apply to this product line when dealing with this category of client? If not, an assessment of the appropriateness of costs and charges should not be warranted.	N/A
Q. 8: If you are acting in an execution only capacity, does the categorisation of the client mean you can apply proportionality to exclude knowledge and experience from a target market assessment?	Yes
Q. 9: If you are acting in an advisory capacity, does the categorisation of the client mean you can apply proportionality to exclude knowledge and experience, financial situation and risk tolerance from a target market assessment?	N/A

Manufacturer obligations		
	Product approval	A governance framework which captures the design of swaps for clients must be established. This should specify the specific underlyers which are approved and the target market for the different varieties of swaps. It will generally not be necessary to implement a distribution governance framework for this product line since the trades are bilateral.
	Target market	Obligation to assess the target market. Given the relatively less sophisticated nature of most swaps, the granularity of the target market can be relatively high level. Also, when dealing with professional clients only, certain limbs of the target market test may be disapplied.[12] No obligations to communicate target market.
	Distribution strategy	No obligation to assess distribution strategy.[13] Therefore, no obligation to communicate the target market.
	Product testing	Product specific analysis needs to be carried out to determine whether stress/scenario testing would be appropriate in the context of the product, taking into account the complexity of the product and the extent to which the product's risk profile and investment proposition was defined by the manufacturer or the client.
	Charging structure	Apply best execution analysis to assess whether the charging structure is compatible with the needs of the target market. However, the charging structure should be made transparent in line with other MiFID II obligations.
	Conflicts of interest	Firms will have to consider whether any conflicts associated with the product sold to a professional counterparty are appropriately managed.
	Information to distributors / investors	Knowledge and experience can be assumed (taking into account complexity of the product) therefore, confirming details of the trade and product parameters should be sufficient.
	Post–sale review	No review required to ensure the product ended up in the hands of the correct target market. Therefore, no obligation to collect management information from distributors. Obligation to monitor market events and communicate these to the counterparty.
	Oversight and training	Oversight and training obligations should result in the limited obligations above being embedded within the business and reviewed on a periodic basis.
	Compliance reports	Compliance reports to the management body should reflect breaches in the limited obligations set out above.

[12] Subject to ESMA finalised guidance.
[13] Article 30(1) & Article 24(2) MiFID II.