Regulation Asia

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Growing Asia's Markets

What You Need to Know About MiFID II Product Governance Requirements

With less than a month to go before the MiFID II comes into effect, Vijay Chander, Executive Director – Fixed Income at ASIFMA (the Asia Securities Industry & Financial Markets Association) answers Regulation Asia's questions about what product distributors and manufacturers in Asia-Pacific need to know.

Regulation Asia: What are the extra-territorial impacts, particularly in Asia-Pacific, of MIFID II (2nd Markets in Financial Instruments Directive) Product Governance requirements?

ASIFMA: MiFID II requirements around product distribution increase the responsibilities of APAC distributors to perform distribution activities on behalf of an EU manufacturer, which are consistent with the agreement(s) between the manufacturer and the distributor.

These include ensuring that the suitability and appropriateness criteria relevant to the investor/target market are met through the provision of a statement(s) to the manufacturer, and providing detailed sales information. The rules also require inducements and potential conflicts of interest are disclosed, and confirmation of the product managers due diligence that the APAC distributor has enhanced KYC (know your customer) requirements.

All of these requirements must be regularly reviewed to ensure they are being met, and distributors should ensure product governance requirements are applied to the distribution of products manufactured before the date of application of MiFID II, January 3 next year, if they continue to be distributed.

One key consideration worth noting is that the distributor obligations are only directly imposed on MIFID firms, but 3rd country distributors facing MIFID manufacturers may be impacted indirectly through contractual obligations.

For Asia Pacific manufacturers whose products are distributed within the EU, the impacts are only indirect. The direct impacts fall on distributors of these products within the EU, who are caught by the guidelines on MIFID II product governance requirements applicable to distributors. Before distributing non-EU products within the EU, EU distributors will require manufacturers to comply with certain minimum standards as laid down by ESMA.

RA: What is the overall objective of the MIFID II Product Governance framework?

ASIFMA: Directive 2014/65/EU on markets in financial instruments introduced the topic of product governance requirements. The rules are outlined in Articles 16(3) and 24(2) of MiFID II, together with additional detailed guidelines in the Commission Delegated Directive (Articles 9 and 10). The origin of the rules around product governance centered on the need to protect retail investors sold complicated and/or risky investment products. These rules have now been expanded to include both retail and wholesale/professional investors, besides the whole range of investment products from non-complex to complex/higher risk products including structured products. EU Investment Firms are the most impacted by the rules, although credit institutions and asset managers such as UCITS funds and AIFMs could also be covered if they provide individual portfolio management and investment advice.

In June 2017, ESMA published its *Final Report* covering the European market regulator's *Guidelines on Product Governance Requirements*. ESMA has specifically provided additional clarity on the topic of the implementation of target market assessment by market participants.

RA: What is the definition of a "Manufacturer" and a "Distributor"

ASIFMA: Product manufacturers relates to investment firms involved in the creation, development, issuance and/or design of investment products and also includes investment firms advising corporate issuers on the launch of new securities.

Product distributors: These are investment firms that offer and/or recommend and sell investment products and services.

RA: What are the main features of ESMA's focus on Target Market Assessment?

ASIFMA: This Target Market Assessment covers manufacturers and distributors of investment products to ensure they act in their clients' best interests at all times.

Guidelines for manufacturers: The rules require a manufacturer to have a product approval process which addresses conflicts of interest, market integrity and ensures the functioning and stability of financial markets is not compromised. In addition, the target market and types of clients for which the product is suitable have to be identified in great detail. Additionally, manufacturers should make available to distributors all relevant information pertaining to specific investment products, the product approval process and the characteristics of the identified target market. Finally, board control and effective compliance oversight must be maintained over firms' overall product governance process – detailed compliance reports containing information about products manufactured by the firm should be submitted to the board.

Guidelines for Distributors: The rules require a distributor to carry out all key steps in the KYC (Know Your Customer) process including suitability and appropriateness, comply with all disclosure requirements, inducements and conflicts of interest. Adequate product governance controls should be in place and the distributor should ensure all information about a product and identified target market is obtained from the manufacturer and is consistent with the needs and objectives of clients within the identified target market(s). Finally, just as with product manufacturers above, effective board control and compliance oversight must be maintained over firms engaged in product distribution, to ensure all aspects of the rules pertaining to product governance are being complied with.

RA: What are the costs and benefits of ESMA's *Guidelines on Product Governance Requirements*?

ASIFMA: ESMA has summarised the main benefits linked to the Guidelines. These include:

Reduction of the mis-selling risk and its related financial consequences;

restoring investors' confidence in financial markets;

positive effects on firms' productivity and efficiency;

reduction of risks linked to regulatory or supervisory arbitrage due to an increased degree of harmonisation across jurisdictions;

more harmonised implementation processes by EU Investment Firms should lead to a reduction in costs; and

reduced regulatory and supervisory costs are also reduced as regulators adopt standardized, harmonised supervisory processes.

Likewise, ESMA has also acknowledged that there are costs associated with the guidelines, including one-off and recurring costs.

One-off costs include initial investments related to implementing a new IT framework**; r**evision of procedural and organisational arrangements, particularly in the areas of business, compliance and legal**; o**rganisational and HR costs related to training staff for newly-revised compliance functions; and Legal costs related to the development of new agreements between manufacturers and distributors.

Recurring costs comprise running IT costs; control and compliance costs; and costs related to the exchange of information between distributors and manufacturers.