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MiFID II / MiFIR seminar

Break-out session 2: Product governance and the sales process

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Aims of this break-out session

- Numerous aspects of the MiFID reforms focus on product governance and the sales process, including:
 - Specific requirements relating to product design and approval
 - Fair, clear and not misleading information
 - Information to clients
 - Inducements
 - Suitability and appropriateness assessments
 - Complaints handling
 - Product intervention
- This session is intended to tie the key threads together, taking a thematic look at the effect of the reforms on product manufacturers and distributors throughout the product life-cycle

Overview of the product life-cycle





MiFID II product governance rules

Level 1 (finalised)

- **completely new regime**
- introduction of **product approval process**
- requirement to **identify the target market**
- products to **meet the needs** of this target market
- **all risks** related to the target market to be assessed
- intended **distribution strategy** consistent with target market
- **understand the features** of product / service
- reasonable steps to ensure product / service **reaches the target market**
- **periodically review** the product, the target market and the distribution strategy
- **distributors / sales intermediaries** understand the product approval process, the target market and the features of the product or service
- board of directors / corresponding governing body to have **effective control** over the aspects mentioned above
- implications for distributors of **third country products**

Level 2 (proposed)

- new organisational requirements in order to reduce, from an early stage, **potential risks of mis-selling**
- product governance arrangements to **apply to provision of investment services**
- **appropriate and proportionate** application
- **two sets of policy proposals**: manufacturers and distributors
- **specific oversight, control and governance obligations** on manufacturers and distributors
- 'distributor' refers to an investment firm that **offers and / or recommends products** to clients
- 'offers' has a wide application and is to be read in a **broad sense**
- firms that **both manufacture and distribute** need not duplicate
- **final distributor in a distribution chain** has ultimate obligation to comply with the distributor requirements
- intermediate distributors in a distribution chain also have certain obligations

Level 2 proposals for manufacturers and distributors

Manufacturers

- procedures and arrangements to manage conflicts of interest in design, creation and development process (including remuneration)
- governance processes for effective oversight and control over design, creation and development process
- assessment of target market – characteristics, needs, objectives
- assessment of risks posed by products and the circumstances that may cause these to occur: scenario analysis
- impact of charging structure on target market considered
- provision of adequate information to distributors so they can understand and sell properly
- regular review of products:
 - ensure the product remains consistent with the needs of the target market
 - ensure the distribution strategy remains appropriate
- positive obligation to check that products function as intended (rather than waiting for detriment to occur), namely:
 - firms to review all investment products prior to any re-launch or re-issue
 - firms to review investment products when aware of an event which could materially affect the potential risk to investors
 - firms to review investment products at regular intervals, based on product complexity, market conditions and other factors

Distributors

- product governance processes to ensure that products and services the firms intend to offer are compatible with characteristics, objectives and needs of the identified target market, and take into account other applicable MiFID conduct of business and organisational requirements
- periodic review of product governance arrangements (robust, and fit for purpose)
- provision of sales information to manufacturers, to assist manufacturers in meeting their post-sale product governance responsibilities
- involvement of compliance function in development and periodic review of product governance arrangements to detect any risk of failure by distributors
- endorsement of the management (or similar) body of the range of products / services offered and respective target markets
- provision of information to senior management in compliance function's periodic reports to management body
- with third-country manufacturers, ensure the level of product information obtained is of a reliable and adequate standard to ensure that products will be distributed in accordance with the characteristics, objectives and needs of the target market

Likely impact in the UK...

- **Little impact** in practice as the UK already has extensive guidance on product governance – the ESMA proposals will mean that some elements of the **UK guidance currently set out in RPPD will need to be elevated to rules**
- Currently, though, there is no presumption that departing from guidance in RPPD indicates a breach of a rule
- The **extension of the requirements** to ‘investment services’ (not just products) is not new in the UK as RPPD already applies to services
- The UK regime is focussed primarily where the end user is a ‘retail client’ so the regime will need to be **extended to apply to other clients**
- But there are differences between MiFID II and ESMA’s proposals, on the one hand, and the UK’s existing regime – so UK regime will need to change to align with ESMA regime
- **More detailed, granular requirements** – impact on the rulebook, consolidation of the requirements and regulator expectations



Information to clients

Level 1 (finalised)

- new obligation on firms to communicate with **ECPs** in a way that is **fair, clear and not misleading**
- new requirements in respect of **investment advice**: it is **independent** / based on a **broad or restricted** range of instruments / will the firm provide a **periodic suitability assessment**?
- information on financial instruments now to **take account of client type and target market**
- clarification and extension of requirements for information on **costs and charges**

Level 2 (proposed)

- information for **retail clients** to be up-to-date and consistently presented in the same language, and to include fair and prominent indications of risk – **strengthening current standards**
- **extension to professionals** of some of the current retail client requirements on fair, clear and not misleading communications
- on investment advice – requirements for a substantial amount of detail to explain the **scope and features of advice**
- additional requirements for **financial instruments**, e.g. restrictions on sale, capital protection/guarantees, performance in a range of market conditions
- significant detail proposed on **costs and charges** – and **extension to ECPs and professional clients** (with the possibility of opt-out except for advice or portfolio management / where instruments embed a derivative)
- requirement for **client agreement** extended to professional clients

Distributor remuneration



Levels 1 / 2

- **NEW BAN!** on independent advisers and portfolio managers **receiving and retaining** payments from third parties
- fees, commission, non-monetary benefits paid **by client or on behalf of client** permitted only where the client is aware of the payment and agrees the amount / frequency
- ‘**minor non-monetary benefits**’ are excluded from this ban (provided they also satisfy the inducement rules)
- ability for independent advisers and portfolio managers to receive minor non-monetary benefits should be **strictly interpreted**
- clarification on what constitutes a ‘**minor non-monetary benefit**’:
 - **exhaustive list** proposed
 - includes information or documentation relating to a financial instrument
 - includes participating in conferences, seminars and other training events on the benefits of a particular financial instrument or investment service
 - includes hospitality of a ‘*reasonable de minimis value*’ (e.g. food and drink during a business meeting)
 - ESMA proposes **restricting the ability for ‘research’** to amount to a ‘minor non-monetary benefit’ – HOT TOPIC!
- **UK independent advisory firms** – no real impact
- **UK restricted advisory firms** – no impact
- **UK portfolio managers** – impact!
- **UK platform service providers** – no impact
- **UK product providers** – no impact when distributing within UK but **impact** when distributing outside the UK

Likely impact in the UK...

- **Significant impact** for UK firms
- **Advisory firms** will need to assess whether they provide independent advice or not and draft appropriate disclosure documents - in the UK, where the concept of independent / restricted advice already exists, the generic disclosure provided by firms in their terms of business may need to be placed into a separate disclosure document or the terms updated to address the additional clarity required
- **All firms will need to reassess their current costs and charges disclosures and update them** to reflect ESMA's proposals (once finalised)
- Will **different versions of the disclosures be required** depending on the particular service a firm might provide to a client?
- Impact on **distribution arrangements** – the UK is already familiar with RPPD in the retail client context
- Interaction with the **UK RDR** – remuneration structures and disclosure of costs (consider also **interaction with PRIIPs**)
- **Significant impact** of ban on inducements for portfolio managers, and for independent advisers dealing with **professional clients**



Suitability



MiFID I on suitability (MiFID Article 19)

When making a personal recommendation or providing portfolio management services to a client or potential client, a firm must obtain the necessary information regarding the client's knowledge and experience, his financial situation and his investment objectives so as to enable the firm to recommend to the client or potential client the investment services and financial instruments that are suitable for him

MiFID II on suitability (Article 25)

A firm must also obtain information about the client's ability to bear losses and risk tolerance in order to ensure that investment services and financial instruments are recommended accordingly

Appropriateness



- MiFID I on appropriateness:
 - When providing services (other than investment advice or portfolio management), a firm must ask their existing or potential clients to provide information regarding their knowledge and experience relevant to the specific type of service or product provided, to enable it to assess whether it is appropriate for the client
- MiFID I on execution only services:
 - Firms are not required to ask their clients to provide information or assess appropriateness if the service is 'execution only', namely, the service consists of execution and/or the reception and transmission of client orders with or without ancillary services, and provided that certain other conditions are satisfied such as the service relates to particular non-complex financial instruments

- MiFID II on appropriateness:
 - The list of financial instruments that fall within the exempted 'execution only' regime, and in relation to which an appropriateness assessment is not required, now covers:
 - Shares admitted to trading on a regulated market, an equivalent third country market or a MTF, where these are shares in companies (except shares in non-UCITS collective investment undertakings and shares that embed a derivative)
 - Bonds and other forms of securitised debt admitted to trading on a regulated market, an equivalent third country market or a MTF (except those that embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved) *
 - Money market instruments (except those that embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved)
 - Shares or units in UCITS (except structured UCITS)
 - Structured deposits (except those that incorporate a structure which makes it difficult for the client to understand the risk of return or the cost of exiting the product before its term)*
 - Other non-complex financial instruments*

* Subject to ESMA guidelines.

Suitability and appropriateness: key points from ESMA



Suitability assessments:

- ESMA recommendations presented as clarifications
- Explicit requirements in MiFID II for investment firms to assess both a client's ability to bear losses and a client's risk tolerance
- Technical advice would supplement current requirements in a number of ways, including:
 - more specific requirements around the reliability of client information obtained (in relation to the ways in which customer information is obtained and subsequently assessed and used by firms)
 - requirements for firms to look through small entities/natural persons representing other natural persons in relation to financial situation and investment objectives (but not knowledge and experience)

Suitability reports:

- MiFID II introduces a specific requirement to supply a written suitability report to retail clients where investment advice is given
- ESMA recommends specific required content, which goes further than current UK requirements set out in COBS 9

Appropriateness

- Further narrowing of the scope of execution-only business
- Instruments not specifically identified as being non-complex would need to meet two new criteria (in addition to those currently specified in the MiFID Implementing Directive) to be considered non-complex:
 - they do not incorporate a clause, condition or trigger that could fundamentally alter the nature or risk of the investment or pay-out profile (e.g. conversion rights)
 - they do not include any explicit or implicit exit charges that make the investment illiquid despite technically frequent opportunities to dispose/redeem
- Explicit clarification that the features listed in Article 38 of the MiFID Implementing Directive (i.e. frequent opportunities to redeem / dispose, availability of information) cannot be used as a means to pull instruments into the non-complex category

Likely impact in the UK...

- **Moderate impact** for UK firms
- The **express references in Level 1 to risk tolerance and ability to bear losses** may not change much of UK firms' existing practice – nor arguably will the explicit requirements in respect of **packaged / bundled services**
- The requirement for **retail clients to be provided with suitability reports** will not change the position for UK firms
- UK firms will, however, need to **update their arrangements and procedures for assessing suitability** to meet the expanded Level 2 requirements
- The changes in relation to **appropriateness** will have a **more substantial impact** – with appropriateness assessments likely to be required in more cases
- Firms will need to re-consider their suite of products and **re-assess whether they can still be sold on an execution-only basis**



Complaints handling: Level 2 proposals



- The new Level 1 text does not change the current regime, however...
- **Completely new requirements** proposed by ESMA to mirror the complaints-handling guidelines that have been proposed for the banking and securities sector (Joint ESMA / EBA guidelines on handling consumer complaints in securities and banking sectors (13 June 2014))
 - requirement to establish and maintain a **complaints management policy**
 - for clients and potential clients
 - provide clear, accurate and up-to-date information about the complaints-handling process
 - endorsed by senior management
 - **publish** details of complaints handling process
 - provide **details of complaints handling process** to clients / potential clients on request or when acknowledging a complaint
 - complaints should be able to be made **free of charge**
 - new **complaints management function** to be established to investigate complaints
 - firms to communicate with complainants in **plain, intelligible language**
 - responses to complaints to be provided **without any unnecessary delay**
 - firms to provide **final position** on complaint and explain options and mention relevant ADR service / option to take civil action
 - **regulatory reporting** of complaints to NCAs (where applicable under Member State law)
 - compliance functions of firms to **analyse complaints data** to ensure they identify and address any issues.
 - ESMA's proposals **do not distinguish between client types** – so currently applicable to retail **and** professional clients
 - ESMA giving itself the flexibility to set out more specific guidelines in the future
 - ESMA does not clarify:
 - what amounts to a “complaint”
 - whether professional clients are subject to the new complaints handling process or whether they can agree a dispute resolution process with a firm contractually

Post-sales handling: Other threads

Product governance requirements for the periodic review of products, their target market and the distribution strategy

Relevant information flows between manufacturers and intermediaries

Positive obligations to review products on a regular basis, including at re-launch or re-issue and where particular risks are identified

Reporting to clients – in particular ex-post disclosure on costs and charges

Management information: product governance issues to be covered in periodic compliance reports

MiFID II product intervention rules

Level 1 (finalised)

- **completely new regime**
- product intervention powers given to **ESMA, the EBA and to national regulators**
- national regulators may impose bans or restrictions
- the EBA and ESMA have similar powers to impose bans / restrictions on an EU-wide basis or for a particular Member State
- certain criteria need to be met, e.g. significant **investor protection concern**, threat to **markets or financial stability**, existing requirements must be **insufficient**, bans / restrictions must be **proportionate** or not have **detrimental effects** on markets / investors
- Action taken by ESMA / the EBA will apply instead of action taken by a Member State national regulator

Level 2 (proposed)

- ESMA has proposed a non-exhaustive list of factors for ESMA and national regulators to consider when determining whether to use product intervention powers, in each of the following areas:
 - **complexity** of the instrument, activity or practice
 - **size** of the potential problem or detriment
 - **type of clients** involved
 - degree of **transparency** of the instrument, activity or practice
 - **features or underlying components** of the instrument or transaction
 - **disparity** between **expected return** or benefit for investors and **risk of loss**
 - ease and cost for investors to **switch or sell**
 - **pricing** and associated costs
 - degree of **innovation**
 - associated **selling practices**
 - **situation of the issuer**

Likely impact in the UK...

- **No major change** for UK firms
- For UK firms, these new powers will not represent a big impact as **the FCA has already had similar product intervention powers since 2012**
- The FCA used these powers for the first time on 24 July 2014, introducing a **temporary restriction on the sale of contingent convertible instruments (CoCos)** to retail clients in the UK from 1 October 2014 for a year
- There are some **key differences** between the two regimes, however, as the new powers are contained in MiFIR - a directly applicable EU regulation - **the FCA may have to align its current product intervention powers with those under MiFIR**
- The **ESMA/EBA powers are new**, however – as is ESMA's **ability to override national regulators** on product intervention, and the **factors proposed by ESMA as a basis for the exercise of product intervention powers**
- ESMA's proposals in relation to **complaints** may require changes to DISP – but may not affect firms significantly in practice depending on the way they currently handle complaints from professional clients

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