

# ESMA Guidelines on MIFID II Compliance – Product Governance Obligations Focus

Following a consultation, on 5 June 2020, ESMA published a final report and [Guidelines on Certain Aspects of the MIFID II Compliance Function Requirements](#) (the "Guidelines").

## Background

The Guidelines provide clarity and consistency on the application of MIFID II requirements for investment firms' compliance function.

The Guidelines, which replace the existing 2012 MIFID I guidelines on the compliance function, supplement core obligations (contained in MIFID II legislation) on the functions and reporting obligations of the compliance function of a MIFID firm.

This update looks at the Guidelines' product governance obligations which relate to a firm's compliance function.

## Scope

As well as applying to MiFID investment firms, the Guidelines are directly applicable to UCITS management companies/AIFMs which are authorised to provide additional MiFID services under the UCITS Regulations/AIFM Regulations, in respect of such additional activity.

## Product Governance Review Requirements

Product governance obligations under MIFID II are broadly split into those relating to firms that manufacture financial instruments (product

manufacturers) and those relating to firms that distribute financial instruments (distributors).

In each case, there is a specific requirement for the relevant firm to regularly review the products they manufacture or distribute.

Section 16 of Schedule 4 of the European Union (Markets in Financial Instruments) Regulations 2017 ("MIFID II Regulations") requires that product manufacturers "*review the financial instruments they devise or otherwise create on a regular basis, taking into account any event that could materially affect the potential risk to the identified target market. Investment firms shall consider if the financial instrument remains consistent with the needs, characteristics and objectives of the target market and if it is being distributed to the target market, or is reaching clients for whose needs, characteristics and objectives the financial instrument is not compatible.*"

Section 23 of Schedule 4 of the MIFID II Regulations requires that distributors regularly review financial instruments they distribute, taking into account any event that could materially affect the potential risk to the identified target market, to assess at least (i) whether the financial instrument remains consistent with the needs of the identified target market; and (ii) whether the intended distribution strategy remains appropriate. This review must take into account "*any event that could materially affect the potential risk to the identified target market*" and involve a consideration of whether the

investment product "remains consistent with the needs, characteristics and objectives of the target market and if it is being distributed to the target market" or is reaching clients outside the target market.

### Compliance Report – Primary MIFID II Obligations

Under Article 22(2)(c) of MIFID Delegated Regulation EU/2017/565, MIFID firms are obliged to provide a written compliance report to the firm's senior management at least annually.

With respect to firms that are product manufacturers, section 1(7) of Schedule 4 of the MIFID II Regulations provides that: "Investment firms shall ensure that the compliance reports to the management body systematically include information about the financial instruments manufactured by the firm, including information on the distribution strategy."

As regards firms that are distributors, section 2(13) of Schedule 4 of the MIFID II Regulations provides that: "Investment firms shall ensure that the compliance reports to the management body systematically include information about the products they offer or recommend and the services provided."

### Guidelines – Compliance/Product Governance

#### Compliance Report

Within Guideline 3 on the reporting obligations of compliance function, it states that the section of the annual compliance report that covers the firm's product governance arrangements should (depending on the nature of the firm's product governance activity e.g. whether it is a product manufacturer or distributor) address at least the following elements:

- **Role of Compliance** – Details on the role of the compliance function in monitoring and

reviewing the firm's product governance arrangements;

- **Review Findings** - Details of findings from compliance review/oversight of the product governance arrangements – to include details of review of the firm's compliance with its product governance policies and procedures, breaches, deficiencies and remedial action taken or recommended; and
- **Product Analysis** – Reporting information, as per the table below.

Systematic Analysis in the Product Governance Section of a Firm's Annual (or more frequent) Compliance Report	
Product Manufacturers	Distributors
Number and nature of products manufactured	Number and nature of products distributed
Analysis of new products launched during the period	Analysis of new products launched during the period
Analysis of any products significantly amended during the period	Analysis of any products significantly amended during the period
Review of existing products	Review of existing products
Target market of products	Target market of products
Details of whether any products are distributed outside their (positive) target market	Details of whether any products are distributed outside their (positive) target market

The Guidelines explain that the purpose of this reporting is to assess whether the firm's product governance arrangements are functioning as intended.

They also note that this analysis may be less in-depth for simpler or more common products, whereas products characterised by complexity/risk features or by other relevant

features (such as, for example, illiquidity and innovation) should be analysed in more detail.

## *Compliance Role in Product Approval Process*

Within Guideline 4 on the advisory and assistance obligations of the compliance function, it states that firms should ensure that the compliance function is involved in the decision-making process when new financial products are being approved and should be given the right to participate in the product approval process for manufacturers and distributors as applicable.

## **Conclusion**

MIFID II developed a range of obligations for a firm's compliance function on its product governance processes. The Guidelines put more detail around these obligations – both in relation to the initial product approval process and the regular reviews that are required.

The Guidelines provide welcome clarity on what needs to be addressed in the compliance function's annual report in relation to the firm's product governance arrangements.

## **Further Information**

For more information on the matters considered in this update, please liaise with your usual Maples Group contact or:

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