Good Practice Guide for Product Distributors and Product Manufacturers - Product Governance MiFID II

This guide has been drafted in anticipation of MiFID II coming into force and is, therefore, intended to assist investment firms in preparing for implementation of the Directive. The guidance takes into account the MiFID II product governance provisions and it will be updated in due course to accommodate the FCA Rules implementing MiFID II (currently subject to consultation).

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Contents

Introduction

MiFID II (the "Directive") introduces specific product governance requirements for investment firms manufacturing financial instruments (products) for sale to clients as well as for investment firms offering or recommending those financial instruments (distributors). In particular, it contains requirements for firms to establish, implement, maintain, operate and review a product approval process for each financial instrument (product) and for significant adaptations of existing financial instruments (products) before they are marketed or distributed/sold to an identified target market of end client(s). While for the UK at least, many of the requirements within the Directive are not new, it is the first time they have been brought together and enshrined within actual rules. This good practice guide aims to combine existing regulatory expectations as set out under the current framework (such as, but not limited to Treating Customers Fairly (TCF), the Roles and Responsibilities of Product Providers and Distributors (RPPD)) along with the more granular requirements in the Directive, and assist firms in developing, designing and assessing their own product governance arrangements against those specified under the Directive. It is worth noting MiFID II does not apply to UCITS, AIFs and their managers but they are indirectly impacted by MiFID II – please see Section 3. However, it does apply to firms distributing UCITS and AIFs.

The product governance rules concern both investment firms that manufacture financial instruments as well as investment firms that distribute them to clients. **This guide provides guidance for firms that distribute products and those that manufacture products.**

The product governance obligations for manufacturers (firms that create, develop, issue and/or design products) include procedures and arrangements to ensure that conflicts of interest are properly managed, governance processes to ensure effective control over the manufacturing process, the assessment of products' potential target market, the assessment of the risks of poor customer outcomes posed, due consideration of product's charging structure, the provision of adequate information to distributors and the regular review of products.

1. Definitions

For the purposes of the Directive, the following definitions apply (see also the Glossary at the end of the document)

Client: means the end investor, regardless of the firm's position within the distribution chain

Product manufacturer: means an investment firm that creates, develops, issues and/or designs financial instruments, including when advising corporate issuers on the launch of new financial instruments[1]

Distributor: means investment firms that offer or sell financial instruments and services to clients[2]

Intermediary: means any firm acting between the product manufacturer and the end client (such as a platform).

2. Scope

The scope of the Directive applies to product manufacturers and product distributors authorized to provide investment services under MiFID as well as indirectly to non-MiFID entities, such as UCITS, Alternative Investment Funds (AIFs) and third county firms. The product governance requirements apply to financial instruments as well as services within the scope of the recast Directive, this extends out to all products sold on primary and secondary markets, irrespective of the type of product or service provided and the applicable requirements at the 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, the investment service and the target market. Proportionality means that these rules could be relatively simple for certain simple products distributed on an execution-only basis where such products would be compatible with the needs and characteristics of the mass retail market[3]. The FCA has stated that it intends to apply the rules to the managers of AIFs and UCITS schemes in the UK[4]. Therefore, product manufacturers of these types of schemes

[1] Commission Delegated Directive 7.4.2016 Recital 15
[2] Commission Delegated Directive 7.4.2016 Recital 15
[3] Commission Delegated Directive 7.4.2016 Recital 18
[4] FCA CP16/29

should assume that the MiFID II product governance rules apply to them as if they were regulated under MiFID II.

Entities which are not subject to the requirements of MiFID II but which may be authorized to perform investment services under that Directive, should also comply, as regards such services, with the MiFID II product governance requirements[5]

The Directive also applies to structured deposits which have been brought within the scope of the regime in order to create a level playing field from an investor protection perspective[6].

It is important to note, that whilst some products and/or financial instruments are not directly caught by the Directive (such as UCITS and AIFs), there are indirect consequential impacts, whereby firms distributing such products will require certain information in order to comply with their obligations. In particular, in relation to identifying a target market of end investor for whom the product is compatible (as well as for whom it is not); information about the product/financial instrument; the product approval process; and information on costs and charges.

3. Application

Investment firms that manufacture[7] or financial instruments are required to comply with the product governance requirements for product manufacturers[8].

Where an investment firm that creates, develops, issues or designs financial instruments is also involved in the distribution of those products, both the product governance rules for manufacturers and distributors apply[9]. While there is no need to duplicate the target market assessment and distribution strategy exercise, firms should ensure that the single target market assessment and distribution strategy exercise is sufficiently detailed to meet the relevant manufacturer and distributor obligations in this area[10].

[5] Commission Delegated Directive 7.4.2016 Recital 16
[6] The definition of structured deposit does not include deposits solely linked to interest rates such as Euribor or Libor, regardless of whether or not the interest rates are predetermined, or whether they are fixed or variable. Such products are out of scope of the Directive.
[7] Manufacturing financial instruments encompasses the creation, development, issuance and/or design of financial instruments
[8] Commission Delegated Directive 7.4.2016 Article 9(1)
[9] Commission Delegated Directive 7.4.2016 Recital 17
[10] Commission Delegated Directive 7.4.2016 Recital 17

Where investment firms collaborate, including with entities which are not authorized and supervised in accordance with MiFID II or third country firms, to create, develop, issue and/or design a product, they must outline their mutual responsibilities in a written agreement[11]
Where firms collaborate to manufacture a financial instrument, only one target market needs to be identified.[12]

4. General Principles

Importantly, there is no one size fits all in relation to product governance and firms should design their processes and practices appropriately and proportionately, taking into account the nature of the financial instrument, the investment service and the target market for the product. In practice, this element of proportionality means that the process could be relatively straightforward for certain simple products that are deemed to match the needs and characteristics of the mass retail market. Whereas for products that are more complex, unusual or likely to be more difficult for investors to understand, a greater degree of effort may be required.
In general, the following have been identified as good practice principles that are intended to help product manufacturers in designing their product governance and product approvals processes:

When providing investment services, or where appropriate, ancillary services to clients, firms must act honestly, fairly and professionally in accordance with the best interests of its clients[13]
Similarly, the obligations for information to be fair, clear and not misleading applies to any relationship with clients[14]. Marketing communications should be clearly identifiable as such[15]
The product governance process should be auditable and transparent
The level of granularity of the target market and the criteria used to define the target market and determine the appropriate distribution strategy should be relevant for the product and should make it possible to assess which clients fall within the target market, for

[11] Commission Delegated Directive 7.4.2016 Article 9(8)
[12] Commission Delegated Directive 7.4.2016 Article 9(9)
[13] MiFID II Article 24(1)
[14] Recital 86
[15] MiFID II Article 24(3)

example, to assist the ongoing reviews after the financial instrument is launched. For simpler, more common products, the target market could be identified with less detail, while for more complicated products such as bail-inable instruments or less common products, the target market should be identified with much more detail[16]

Investment firms should comply with the relevant requirements in a way that is appropriate and proportionate, taking into account the nature of the financial instrument, the investment service and the target market for the product[17]

Where the Directive requires information to be provided in "good time" to clients or potential clients, firms should take into account, having regard to the urgency of the situation, the client's (or potential client's) need for sufficient time to read and understand the information before making an investment decision. Further, that a client is likely to require more time to review information given on a complex or unfamiliar product or service, or a product or service a client has no experience in, than with a client considering a simpler or more familiar product or service, or where the client has prior experience[18]

5. The product lifecycle

When designing and implementing the product governance requirements, firms may find it helpful to consider these in the context of a "product lifecycle". While there is no standard definition of a "product lifecycle", this is generally understood to mean everything from idea generation, design and launch, distribution and marketing, on-going maintenance through to termination of the product.

Importantly, a product may not stay the same for the whole of its "lifecycle". There may be many reasons why a product changes such as, for example, a change in investment objectives through a change in strategic investment focus or, through a merger with another product. If/when a product changes firms will need to consider whether the change is such that it constitutes a "significant adaptation[19]" of the existing product and, consequently, whether the product needs to go through the relevant steps of the product approval process again.

[16] Commission Delegated Directive 7.4.2016 Recital 19
[17] Commission Delegated Directive 7.4.2016 Article 9
[18] MiFID II Recital 83
[19] The concept of what constitutes a "significant adaptation" of an existing product is not defined within the Directive but is discussed further in section 12 of this good practice guide

6. Organizational and operating requirement

6.1 Management body

Summary of requirements

In relation to product governance, the management body is required to define, approve and oversee a policy as to services, activities, products and operations offered or provided, in accordance with the risk tolerance of the firm and the characteristics and needs of the clients to whom they will be offered or provided, including carrying out appropriate stress testing, where appropriate[20].

The Directive requires the management body of an investment firm to have effective control over the firm's product governance process[21].

It also requires investment firms to establish, implement and maintain decision making procedures and an organizational structure which clearly, and in a documented manner, specifies reporting lines and allocates functions and responsibilities as part of the general organizational requirements[22]

In addition, the management body is required to monitor and periodically assess the adequacy and implementation of the firm's strategic objectives in the provision of investment services and activities and ancillary services, the effectiveness and the adequacy of the investment firm's governance arrangements and the adequacy of policies relating to the provision of services to clients and take appropriate steps to address any deficiencies[23].

Good practice guidance

In the UK, it is likely that the management body is the Board of the investment firm. However, in many firms the "management body" as defined under the Directive is not necessarily the same group of individuals who operate the product governance or product approval arrangements. As good practice, firms should consider how activities and responsibilities of the management body are delegated through the corporate governance structure, through, for example, formal delegation agreements. Depending on how they are

[20] MiFID II Article 9(3)(b)
[21] Commission Delegated Directive 7.4.2016 Article 9(6)
[22] Commission Delegated Regulation of 25.4.2016 Article 21(1)(a)
[23] MiFID II Article 9(3) sub para (3)

structured, some firms may even establish a dedicated Product Governance/Product Approval Committee (see organizational arrangements).

For firms that operate Group structures with functional reporting, consideration is likely to be needed to be given to the governance and oversight arrangements that are envisaged to be performed by the management body since MiFID applies at an entity level rather than at a Group level.

Generally, it is considered good practice to set out the firm's approach to product governance and product approvals in a product approval policy which clearly describes: the product approval process; the firm's policy in respect of product approval, including changes to existing products; which products/changes require approval by whom; and when changes do not need to be approved.

Depending on the size of the firm, some may wish to establish and maintain a dedicated Product Development/New Product Approval Committee etc. Where such Committees/forums are established, it is good practice to set out their roles and responsibilities in writing (such as a Terms of Reference) which includes matters such as (as relevant): frequency of meetings; conflicts of interest identification and management; investor interests; market integrity; voting rights; quorum requirements; reporting lines and escalations; as well as any delegations from the management body etc.

Any delegations of authority should be clearly defined and formally documented. Firms should also remain aware of the distinction between delegating the authority for an activity versus delegation of responsibility, as the latter will remain the responsibility of the MiFID firm and cannot be delegated to a Product Committee. It is important to note that where authority has been delegated by the management body to another Committee/functional area/individual(s) that it is clear who that authority has been delegated to and under what remit. This should include clearly defined and appropriate escalation routes as well as reporting obligations back to the management body.

6.2 Product Governance Composition

Summary of requirements

The make-up of the product governance arrangements is a key aspect in ensuring the effectiveness of their operation in practice. It is crucial that the arrangements in place include:

Individuals with an adequate level of standing and authority;

Individuals with sufficient skills and expertise collectively to understand the product and its features, as well as any associated risks;

Provide sufficient opportunity for assessment, scrutiny, review and challenge

Good practice guidance

In order to strike the right balance it is likely (depending on the size of the firm) that the product governance arrangements will need to comprise senior representatives (e.g. 'Heads of') from a broad range of business functional areas (such as, for example, a mixture of Product Development staff as well as senior representatives from Investment, Distribution, Marketing, Operations, Compliance, Finance, Legal, Tax and Risk) at some stage in the process prior to product approval, as well as to provide on-going oversight post launch.

6.3 Staff skills, knowledge and expertise

Summary of requirements

Investment firms are required to understand the features of the financial instruments offered or recommended and establish and review effective policies and arrangements to identify the category of clients to whom products and services are to be provided[24]

The Directive requires firms to ensure that relevant staff involved in the manufacturing of financial instruments possess the necessary expertise to understand the characteristics and risks of the financial instruments they intend to manufacture[25] before they are manufactured. In particular, firms may wish to consider/address training needs if they are considering developing a type of product which they have not launched before and/or exploring new investment capabilities - which may require specific training, even for existing staff.

Good practice guidance

As good practice, firms should ensure that role profiles and/or job descriptions clearly define the level of skills and expertise required for the performance of a particular function, in addition to setting out expectations in terms of role and responsibilities. Knowledge and experience/expertise should be regularly tested through for example, performance management processes and staff appraisals which should be formally documented.

Any training and development needs identified should be followed up and appropriately addressed on a timely basis. It is for firms to decide how to assess knowledge and

[24] MiFID II Recital 71
[25] Commission Delegated Directive 7.4.2016 Article 9(5)

competence in the absence of any specific regulatory requirements, as well as how to appropriately address any training or development needs identified.

7.4 Role of Risk and Compliance

Summary of requirements

The Directive contains explicit provisions in relation to Risk and Compliance. For example, there are requirements for firms to establish, implement and maintain adequate risk management policies and procedures which identify the risk relating to the firm's activities, processes and systems, set the level of risk tolerated by the firm[26]; where appropriate and proportionate in view of the nature, scale and complexity of their business and the nature and range of the investment services and activities undertaken in the course of that business, establish and maintain a risk management function that operates independently and carries out certain specified activities[27]; and to establish, implement and maintain a permanent and effective compliance function which operates independently carrying out certain specified activities[28].

In the context of Product Governance there are specific requirements for Compliance to monitor and/or oversee the development and periodic review of the product governance arrangements in order to detect any risk of failure by the firm to comply with its obligations in relation to product governance[29].

Good practice guidance

As good practice firms should involve Compliance as well as other key staff from the second line of defense, such as Risk and Investment Risk, in their product governance arrangements to ensure they are engaged early on in the process in order to identify and assess:

- Regulatory issues and/or risks;
- Risks that could lead to poor product design and/or unexpected customer outcomes; and/or
- Inherent flaws in the product idea/design;
- Whether the product objectives can be achieved within acceptable risk parameters;

[26] Commission Delegated Regulation 25.4.2016 Article 23(1)
[27] Commission Delegated Regulation 25.4.2016 Article 23(2)
[28] Commission Delegated Regulation 25.4.2016 Article 22(2)
[29] Commission Delegated Directive 7.4.2016 Article 9(7)

- Performance/oversight of the required scenario analysis and stress testing to assess risk/reward parameters and likely payout profile;
- That instruments and techniques proposed to be used are within the risk appetite and investment capabilities of the firm;
- That risks are appropriately disclosed;
- Performance/oversight of the calculation and results of risk metrics;
- That risks have been appropriately identified and addressed e.g. operational issues, technology, pricing including performance fees, capacity constraints etc.

Where the size of a firm is such that the Risk and/or Compliance function is split into a number of units (e.g. Risk and Investment Risk; or for Compliance a business advisory unit and a monitoring unit), firms should consider using different teams for involvement in product development and monitoring activities respectively. This allows for a degree of independent oversight as well as additional review, scrutiny and challenge.

7.5 Remuneration

Beyond conflicts of interest requirements, the Directive contains explicit remuneration provisions that relate to product governance[30]. In particular, firms that provide investment services to clients are required to ensure that they do not remunerate their staff in a way that conflicts with its duty to act in the best interests of its clients.

7. Product Governance arrangements for product manufacturers

8.1 Product Approval process

Summary of requirements

MiFID II requires investment firms which manufacture financial instruments for sale to clients to maintain, operate and review a process for the approval of each financial instrument and significant adaptations of existing financial instruments before they are marketed or distributed to clients[31].

The product approval process should specify an identified target market of end clients within the relevant category of clients for each financial instrument and should ensure that all

[30] Commission Delegated Regulation 25.4.2016 Article 27
[31] MiFID II Article 16(3) sub para 2

relevant risks to such identified target market are assessed and that the intended distribution strategy is consistent with the target market[32].

Good practice guidance

The product approval process should be auditable, transparent and should reflect what actually happens in practice. As good practice, firms should consider including the following matters within their product governance process and ensure that rationale and decision making in this regard is fully documented:

- Client rationale - e.g. identification of target market of end client, client needs and how the proposed product is compatible with the identified target market, as well as for whom the product is not compatible
- Opportunity – e.g. rationale of conducive factors to launch the proposed product at this time e.g. economic/investment/regulatory environment; specific market analysis; length of opportunity; competitor analysis
- Investment proposition – e.g. investment objectives, performance and risk targets; investment policy; time horizon; likely investor usage; liquidity; identification of product complexity (or otherwise); investment feasibility and capability; strategy capacity; stress testing and scenario analysis; position within the existing product range
- Distribution – e.g. intended distribution strategy (such as distribution channels) and how this is appropriate for the identified target market; results of distributor due diligence (as relevant); sales forecasts; marketing strategy; results of any product testing; details of fees and charges; and regulatory/registration requirements
- Operations – e.g. operational feasibility; resource; set up costs and timescales as well as any on-going product management; and any third parties involved in the product launch or operation
- Risk and Compliance – e.g. results of stress testing and scenario analysis from an investor outcome perspective; identification of crucial events; specific risk factors and their proposed mitigation; conflicts of interest identification and management; reputational risk; proposed ongoing monitoring; identification of any specific training needs (both internal and external)

[32] MiFID II Article 16(3) sub para 3

- Regulatory considerations – e.g. proposed legal structure and domicile; any local registration/selling restrictions; regulatory application process; reporting requirements; any other regulatory considerations/issues/risks.
- Tax considerations – for example relating to the investment strategy, jurisdiction of domicile, specific client types
- As good practice firms may find it helpful to design product approval templates that set out the factors to be taken into consideration when deciding whether or not to approve products. Templates (provided they are appropriately designed and correctly used) can also help to meet the FCA's expectations in relation to "evidencing" that all matters were considered and signed off by relevant/appropriate individuals and how the product approval process operates in practice.

8.2 Product design – identifying investor needs

Summary of requirements

Firms that manufacture financial instruments for sale to clients are required to ensure that those financial instruments are designed to meet the needs of an identified target market of end client within the relevant category of clients[33]. The potential target market needs to be identified at a sufficiently granular level for each financial instrument and to specify the type(s) of client for whose needs, characteristics and objectives the financial instrument is compatible. As part of this process, firms are required to identify any group(s) of clients for whose needs, characteristics and objectives the financial instrument is not compatible[34]. Investment firms manufacturing financial instruments that are distributed through other investment firms should determine the needs and characteristics of clients for whom the product is compatible based on their theoretical knowledge of, and past experience with, the financial instrument or similar financial instruments, the financial markets and the needs, characteristics and objectives of potential end clients[35]

When determining whether a financial instrument meets the identified needs, characteristics and objectives of the target market, firms should examine:

a) Whether the financial instrument's risk/reward profile is consistent with the target market; and

[33] MiFID II Recital 71, Article 24(2)
[34] Commission Delegated Directive 7.4.2016 Article 9(9)
[35] Commission Delegated Directive 7.4.2016 Article 9(9)

b) Financial instrument design is driven by features that benefit the client and not by a business model that relies on poor client outcomes in order to be profitable[36]

Good practice guidance

As good practice in identifying investor needs, firms should undertake a variety of analysis including, for example:

- Market research;
- Attending industry forums;
- Consulting with distributors;
- Customer Research – e.g. holding "focus groups" with end investors.

As part of on-going monitoring, firms should assess that the product design continues to be consistent with the needs, characteristics and objectives of the identified target market.

As good practice, firms should be able to demonstrate how a particular product is compatible with the needs, characteristics and objectives of the identified target by setting out how they have considered (at least) the following elements:

- How the product objectives are likely to meet the needs of the identified target market of end client within the category of clients;
- That the financial instruments risk/reward profile is consistent with the needs of the identified target market;
- That the product is commercially viable and the design is not driven by a business model that relies on poor customer outcomes in order to be profitable[37];
- That the financial instrument design is driven by features that benefit the client;
- That the charges are appropriate, transparent and not likely to undermine the product return expectations.

8.3 Identification of target market

Summary of requirements

The product approval process needs to specify an identified target market of end client within the relevant category of clients, the needs, characteristics and objectives of which the product has been designed to fulfill. This is a requirement for each financial instrument as well as for significant adaptations of existing financial instruments before they are marketed

[36] Commission Delegated Directive 7.4.2016 Article 9(11)
[37] Commission Delegated Directive 7.4.2016 Article 9(11)

or distributed to clients. In order to comply with the Directive, a firm should specify at a sufficiently granular level the potential target market for each financial instrument and specify the type(s) of client for whose needs, characteristics and objectives the financial instrument is not compatible. If the product manufacturer collaborates with another firm to manufacture a financial instrument, only one target market needs to be identified[38].

The level of granularity of the identified target market and the criteria used to define the target market and determine the appropriate distribution strategy should be relevant for the product and should make it possible to assess which clients fall within the target market, for example, to assist with on-going reviews after the product is launched. For simpler, more common products, the target market identification could be quite broad whereas for more complicated or less common/unusual products, the target market may need to be defined in more specific detail.

The target market selection should also take into account the complexity of the product[39] and the likely level of investor sophistication within that target market, as well as how the product will be distributed (such as with or without advice). Firms should aim to ensure that the complexity of the product is a reasonable match to the likely level of understanding of the target market in order to provide investors with a fair opportunity to properly evaluate the product and to understand the potential outcomes (including the possibility of the product behaving counter intuitively, the possibility of receiving no return at all, or the possibility of making a loss).

Good practice guidance

Defining target markets at a sufficiently granular level of detail can be challenging, particularly when products have been designed to address the needs of a broad range of investors. MiFID II recognizes that where the product manufacturer is in an intermediated distribution chain[40] that identifying client needs and characteristics for whom the product is compatible may require firms to hypothesize on likely investor needs based on their theoretical knowledge of and past experience with the financial instrument or similar financial instruments, the financial markets and the needs and objectives of potential end clients[41] in order to inform their understanding and product design process.

[38] Commission Delegated Directive 7.4.2016 Article 9(9)
[39] Commission Delegated Regulation 25.4.2016 Article 57
[40] i.e. where products/financial instruments are distributed through other investment firms such as intermediaries
[41] Commission Delegated Directive of 7.4.2016 Article 9(9) sub para (2)

As good practice when identifying target markets for their products, firms should consider (and fully document) factors such as:

- What the product is for e.g. the investment viewpoint that is encapsulated in the product strategy;
- The nature and risks presented by the product such as: liquidity, volatility and/or risk of capital loss;
- Typical time horizon over which the product should be held;
- Product usage – and whether the product would best be incorporated as part of a portfolio of investments;
- How the product will be distributed;
- Assumed level of required investor understanding taking into account the identified target market and the distribution strategy;
- Clarity of descriptions contained in documentation;
- Investor access – such as product complexity and whether or not the product requires an appropriateness test – including any appropriateness test calibrations that may be used by distributors that the firm is aware of.

While the product manufacturer is required to identify a target market, this does not relieve the distributor of its own obligations to identify an appropriate target market, even if the target market is not defined by the manufacturer and distributors are required to use the information obtained from product manufacturers and information they hold on their own clients in order to identify the target market and distribution strategy.

8.4 Identification of risks

Summary of requirements

The identification of risks is a crucial element in the product development process as well as through ongoing monitoring. As part of the product approval process, the Directive requires investment firms to ensure that all relevant risks to the product's target market are identified and assessed and to consider whether the financial instrument may represent a

threat to the orderly functioning and stability of financial markets before deciding to proceed with the launch[42].

Good practice guidance

The identification of both generic and specific product risks through the product approval process – including stress testing and scenario analysis – should help to inform the regularity of product reviews, levels of monitoring etc. as well as the identification/implementation of mitigants. This should also help to inform the selection and inclusion of appropriate risk warnings and disclosures to be contained in relevant product documentation.

Risks should be monitored and assessed in both pre-launch and post-launch monitoring. As good practice, the outputs of risk identification and assessment exercises should be formally documented and reviewed by relevant management.

8.5 Performing stress testing

The Directive requires firms to put in place a policy as to services, activities, products and operations offered or provided in accordance with the risk tolerance of the firm and to carry out stress testing, where appropriate[43].

The aim of stress testing is to identify how products and services are likely to perform in a range of market conditions, and how the investor could be affected. As good practice, stress tests should be designed to be both forward and backward looking in predicting and anticipating future returns and payout profiles.

Stress tests should also analyze the resilience of the product over the proposed term or anticipated holding period so that the product's risk profile can be properly assessed both at outset and on an on-going basis.

8.6 Scenario analysis

Summary of requirements

In addition to stress testing, firms are required to undertake a scenario analysis of their financial instruments which should assess the risks of poor customer outcomes for end

[42] MiFID II Article 16(3) sub para 3 and Commission Delegated Directive 7.4.2016 Article 9(4)
[43] MiFID II Article 9(3)(b)

clients posed by the product and in which circumstances these may occur. In particular, firms are required to assess the financial instrument under negative conditions covering what would happen if, for example:

a) The market environment deteriorated, such as a crash in the equity markets or a rise in interest rates; or specific global events such as the 2008 financial crisis
b) The manufacturer or third party involved in manufacturing and/or functioning of the financial instrument experiences financial difficulties or other counterparty risk materializes;
c) The financial instrument fails to become commercially viable; or
d) Demand for the financial instrument is much higher than anticipated, putting a strain on the firm's resources and/or on the market of the underlying instrument[44]

Good practice guidance

It is, of course, for firms to decide how to stress test their products and how to undertake scenario analysis including the conditions under which such procedures will be performed, in a way that is appropriate and proportionate. As an overarching principle, stress tests and scenario analysis should be performed consistently and firms should formally document their approach to this, for example via a formal stress testing/scenario analysis policy.

8.7 Identification of crucial events

Following on from stress testing and scenario analysis, the Directive requires manufacturers to identify crucial events that would affect the potential risk or return expectations of the financial instrument, such as:

a) the crossing of a threshold that will affect the return profile of the financial instrument; or
b) the solvency of certain issuers whose securities or guarantees may impact the performance of the financial instrument[45]

8.8 Identification of conflicts of interest

Summary of requirements

[44] Commission Delegated Directive 7.4.2016 Article 9(10)

[45] Commission Delegated Directive 7.4.2016 Article 9(15)

Conflicts of interest identification, management and disclosure (where necessary) is one of the key areas receiving increasing regulatory scrutiny. It forms a core part of the enhancements to investor protection under the recast Directive.

Specifically, there are requirements for firms to ensure that the design of the financial instrument, including its features, does not adversely affect end clients or lead to problems with market integrity by enabling the firm to mitigate and/or dispose of its own risks or exposure to the underlying assets of the product, where the investment firm already holds the underlying assets for its own account[46].

In addition, firms are required to conduct an analysis of potential conflicts of interest each time a financial instrument is manufactured and assess whether the financial instrument creates a situation where end clients may be adversely affected if they take:

a) an exposure opposite to the one previously held by the firm itself; or
b) an exposure opposite to the one that the firm wants to hold after the sale of the product[47].

Good practice guidance

Conflicts of interest assessments and analysis (including conflicts of interests with third parties) should be documented and firms should consider the extent to which these can be appropriately managed and mitigated (and as a last resort disclosed) through the firm's controls or if additional controls are required to be implemented.

In circumstances where the firm reaches a conclusion that conflicts of interest cannot be managed with a reasonable level of confidence, or that the risks of damage to client interests will be prevented, the general nature and/or sources of conflicts of interest and the steps taken to mitigate those risks should be clearly disclosed to the investor before the firm undertakes business on their behalf. Such disclosures must be made in a durable medium and include sufficient detail, taking into account the nature of the client, to enable that client to make an informed investment decision in the context of which the conflict of interest arises[48]. Conflicts of interest disclosures should only be used as a last resort.

[46] Commission Delegated Directive 7.4.2016 Article 9(2)
[47] Commission Delegated Directive 7.4.2016 Article 9(3)
[48] MiFID II Article 23(1)(2)

8.9 Costs and charges/charging structure

The Directive contains explicit provisions that require product manufacturers to consider the charging structure proposed for a financial instrument, including by considering the following elements:

a) the financial instrument's costs and charges are compatible with the needs, objectives and characteristics of the target market;
b) The charges do not undermine the financial instrument's return expectations, such as where the costs or charges equal, exceed or remove almost all of the expected advantages linked to a financial instrument; and
c) The charging structure of the financial instrument is appropriately transparent for the target market, such as that it does not disguise charges or is too complex to understand[49].

There is no one approach to assessing whether costs and charges meet the set requirements. However, ESMA has provided some guidance[50] in terms of areas that firms should consider which could act as a useful source of information. Clearly, not all of ESMA's criteria will be relevant to every firm or in every case.

8.10 – Roles and responsibilities of manufacturers

8.10.1 Identification of appropriate distribution channels

Summary of requirements

In addition to identifying a target market of end client for whom the product if compatible, product manufacturers are also required to ensure that the intended distribution strategy is compatible with the identified target market[51].

Good practice guidance

Good practice includes assessing whether the product is one that should be restricted e.g. only sold with advice – for example, products with particularly complex features that may make them difficult for the end investor to understand or whether it is a product designed for mass market retail investors. Particular care should be taken with the use of execution only channels and non-advised channels, especially where products have complex features or other elements that make them difficult for an investor to understand. The identification

[49] Commission Delegated Directive 7.4.2016 Article 9(12)
[50] ESMA Technical Advice to the Commission on MiFID II and MIFIR 19.12.2014 Section 2.14
[51] MiFID II Article 24(2)

of appropriate distribution channels should also include consideration of whether the product in question requires an appropriateness test before it can be bought by investors. If firms decide to restrict the distribution channel for a particular product, examples of actions they could take are:

- Not issuing direct offer financial promotions to certain categories of clients or suggesting that if the investor is uncertain about whether or not to invest they should seek advice;
- Considering whether the product features are sufficiently complex such that a prospective investor should undergo an appropriateness test;
- Limiting distribution to a subset of the distribution population;
- Limiting investor access – such as not putting the product on an execution only platform.

Where firms elect to restrict the distribution channel for a particular product, they should ensure that they have adequate arrangements in place to ensure the control can be monitored.

8.10.2 Distributor oversight – initial and on-going

Summary of requirements

Distributor oversight can play a useful role in product manufacturers meeting their responsibilities in terms of ensuring that products and services are sold only to the identified target market on an initial and ongoing basis as well as when selecting appropriate distribution channels.

To this end, it is helpful for product manufacturers to understand their key distributor relationships, including the distributor's target market of end investors. To be clear, this responsibility does not extend to assessing suitability or appropriateness where the product manufacturer is operating within an intermediated distribution process. Suitability and appropriateness obligations rest solely with the distributor.

Good practice guidance

One way in which product manufacturers could develop their distributor oversight strategy could be to undertake appropriate due diligence on their distributors both at an initial and on an ongoing basis. As good practice, generally this is more than simply checking and placing reliance on regulatory status (where intermediaries are regulated). By way of example, a distributor due diligence program could include:

- Initial due diligence - which should include an assessment of any risks posed to the fulfilment of the firm's legal and regulatory responsibilities; and
- Continuing due diligence – which should include monitoring their distributors to ensure that products are reaching their target market. This might also include planned regular reviews of the largest distributors to understand whether their sales fits with the initial target market assessment. Where there is a difference, this might require additional remediation actions or other further activities.

Due diligence should, of course, be appropriate and proportionate taking into account the product complexity, target market, likely investor usage and risk profile as well as any risks posed by a using a particular distribution channel. Importantly, distributor oversight should not be overly complex or cumbersome but should be designed in a way that enables the product manufacturer to be satisfied as far as is practicable that its products will and are be(ing) sold in line with the identified target market and that the distribution strategy remains appropriate.

8.10.3 Information to distributors

Summary of requirements

The Directive requires product manufacturers to make available to any distributor all appropriate information on the financial instrument and the product approval process, including the identified target market of the financial instrument[52]. In particular, the provision of information about a financial instrument to distributors must include information about the appropriate channels for distribution of the financial instrument, the product approval process and the target market assessment. Information must be of an adequate standard to enable distributors to understand and recommend or sell the financial instrument properly[53].

The requirements for distributors to obtain information from product manufacturers applies whether or not the product manufacturer is within the scope of the Directive[54]. This obligation is relevant for products sold on primary and secondary markets and applies in a

[52] MiFID II Article 16(3) sub para (5)
[53] Commission Delegated Directive 7.4.2016 Article 9(13)
[54] MiFID II Recital 71, Commission Delegated Directive 7.4.2016 Article 10 (1) sub para 2, 10(2) sub para 2

proportionate manner, depending on the degree to which publicly available information is obtainable and the complexity of the product[55]. Acceptable public information is information which is clear, reliable and produced to meet regulatory requirements, such as disclosure requirements under the Prospectus Directive or the Transparency Directive.

Good practice guidance

When preparing information for distributors, good practice includes considering how that information might be used with or provided to end investors. Firms should also assess the extent to which they allow distributors to produce their own marketing materials for the firm's products and what arrangements the distributor has in place to ensure that product material is fair, clear and not misleading – this could be assessed, for example, through the firm's distributor due diligence process as relevant. Any limitations or caveats, for example, permission for the distributor to only use the product provider's marketing materials should be agreed in writing, for example, this could form part of the general terms of business or intermediary agreements etc.

Information intended for professional use only should be clearly marked and firms should take all reasonable steps (to the extent practicable) to try to ensure such information is only received by the intended audience.

Manufacturers will be required to make available the following information to distributors:

Information Type	**Description**	**Format**	**Best Practice Reference**
Costs and charges	Product manufacturers will need to provide distributors with additional information about product costs and charges in order to enable those distributors to meet their obligations to their clients (the end investor).	Data & appropriate fund documentation	Section 8.9 of the TISA Best Practice Guide
Complex and non-complex indicators	*Product manufacturers will need to provide distributors with an indicator of whether they deem their*	Data & appropriate fund documentation	TISA Appropriateness Best Practice Guide

[55] Commission Delegated Directive 7.4.2016 Article 10(2) sub para 3

	product to be complex or non-complex. Where they deem the product to be complex information shall be provided to show how the product satisfies the Article 57 criteria in order to support their position.		
Product approval process	Manufacturers will need to provide information to distributors about the product approval process	Documentation	Section 8.1 of the TISA Best Practice Guide
Target Market description	Manufacturers will need to provide information to distributors about the intended target market for its funds	Data & appropriate fund documentation	Appendix TBD of this document

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When providing this information to distributors, product manufacturers should consider whether distributors would need additional information, to supplement the standard documentation, to enable them to understand the product well enough to give suitable advice (where advised sales are envisaged) and to extract any relevant information and communicate it to the end investor.

As part of meeting this standard, product providers should consider – with regard to each distribution channel or type of distributor – what information distributors of that type already have, their likely level of knowledge and understanding, their information needs and what form or medium would best meet those needs (which could include discussions, written material or training as appropriate).

8.10.4 On-going assessment

Summary of requirements

Under MiFID II, product manufacturers are required to regularly review the financial instruments it offers or markets, taking into account any event that could materially affect the potential risk to the identified target market, to assess at least whether the financial

instrument remains consistent with the needs, characteristics and objectives of the identified target market and whether the intended distribution strategy remains appropriate[56].

In addition, manufacturers are required to review financial instruments prior to any further issue or re-launch, if they are aware of any event that could materially affect the potential risk to investors and at regular intervals to assess whether the financial instruments function as intended[57].

It is up to the product manufacturer to decide how regularly to review their financial instruments. However, the frequency of the review should be based on relevant factors, including factors linked to the complexity or the innovative nature of the investment strategies pursued[58].

Good practice guidance

From an operational perspective, many firms conduct a specific post-launch analysis outside of their regular ongoing monitoring. The aim of post-launch analysis is to obtain early analysis of any potential issues with a new product or to identify and feedback any "lessons learned".

There are a number of factors that a product governance process could consider as good practice in a post launch analysis, for example:

- Conducting post launch reviews at appropriate points to assess the success of operational implementation in order to identify any issues that should be fed back into the product development process;
- Is the product operating in line with its stated objectives and risk profile and in accordance with what investors have been led to expect?
- Is the product being sold in line with the identified target market?
- Are there any investment mandate breaches, errors or incidents that should be reported to clients and/or distributors?
- Are there any lessons learned that should be fed back into future product approvals/launches?
- Any feedback from distributors?

[56] MiFID Article 16(3) sub para(4)
[57] Commission Delegated Directive 7.4.2016 Article 9(15)
[58] Commission Delegated Directive 7.4.2016 Article 9(15)

In practice, on-going product reviews are likely to involve the collection and analysis of appropriate management information that enables the product manufacturer to detect patterns in distribution, particularly in the identification of any deviations and/or outliers from what was originally intended.

How products manufacturers use any product-related management information will depend upon manufacturer-specific considerations. However, in order to provide an objective and consistent assessment process which will provide a robust audit trail, product manufacturers may wish to develop some form of documented product behavioural assessment process which enables the RAG rating of products. Such an approach can enable product manufacturers to focus their attention on products which may be showing signs of 'stress' or behaving in an unexpected fashion which, in turn, may suggest the potential for investor detriment.

Appendix 1 sets out some high-level practice guidance regarding the type of management information which could be considered as relevant for product monitoring. The breadth and granularity of product data which is appropriate for a given product manufacturer will depend on a number of factors, for example:

- how diverse its product range is and the types and complexity of the products offered;
- how broad and/or complex its distribution model is;
- whether the product manufacturer is a stand-alone provider or part of a larger financial group (for example, alongside other product manufacturers and distribution channels).

Consideration may be given to whether risk attributes are inherent or static in a product (e.g. pricing or dealing frequency, complexity, derivatives use) or are dynamic (e.g. complaints, investment performance, flows) and the relative weighting assigned to such attributes and data in determining the overall behavioural risk a given product exhibits.

8.10.5 Monitor product sales and sales channels

Summary of requirements

Investment firms are required to assess whether the product is reaching the clients for whose needs, characteristics and objectives it was not considered compatible[59]. Investment

[59] Commission Delegated Directive 7.4.2016 Article 9(14)

firms are also required to take reasonable steps to ensure that the financial instruments are distributed to the identified target market and periodically review the identification of the target market of and the performance of the products they offer[60]

Good practice guidance

Importantly, under MiFID II there are requirements for product distributors to make available relevant information to product manufacturers[61] which in turn product manufacturers can use to help inform their ongoing product monitoring and review process – including the identification of "crucial events".

As per the ESMA Consultation Paper (1436) **"manufacturers should; consider, on a proportionate basis, what information they need in order to complete their review and how to gather that information…Such information may be in an aggregated form and does not need to be on an instrument by instrument or sales by sales basis".**

Distributors should periodically inform manufacturers about their experience with the products and; while distributors are not required to report every sale to manufacturers they should provide the data that is necessary for the manufacturer to review the product and check that it remains consistent with the needs, characteristics and objectives of the target market as defined by the product manufacturer.

Relevant information could include data about the amount of sales outside the manufacturer's target market, summary information about the types of clients, a summary of complaints received or by posing questions suggested by the manufacturer to a sample of clients for feedback[62].

Distributors already provide some data back to manufacturers in terms of sales and distribution channels this typically includes: name of the first intermediate distributor, name of the end distributor, end distributor FCA number, fund name, and cash flow data. It would be sensible for manufacturers to look at what is already provided by distributors and build on this.

Manufacturers will require three additional elements of the target market criteria to perform their initial assessments –

1. Type of client

[60] MiFID Recital 71, MiFID II Article 16(3) sub para 4
[61] Commission Delegated Directive 7.4.2016 Article 10(9)
[62] Commission Delegated Directive 7.4.2016 Recital 20

2. Distribution channel
3. Results of any appropriateness tests conducts for complex products

The target market definition is categorized into 6 broad categories - client type, knowledge & experience, ability to bear losses, client needs, client objectives and risk. These categories are intended to inform decision making by both product providers and distributors.

The Knowledge & Experience category is the driver of decision making for product providers, informing the Client Type and Distribution Channel, as well as the marketing strategy.

The remaining categories are provided as information to aid distributors in the selection or filtering of products for recommendation to end investors receiving advice or portfolio management services. They do not inform decision making by the product provider.

The role of target market oversight is to evaluate whether the product sales align to the expectations defined by the product provider's product governance process - in other words has the product been sold to the expected client type(s) and distribution channel(s)? It is not to oversee the recommendations of distributors.

Consequently, in terms of transaction reporting, a breakdown by client type and distribution channel is sufficient. This may be supplemented by a review of the results of the appropriateness assessment for sales of complex products sold through execution only channels, to enable product providers to evaluate whether a particular complex product is suited to sales via execution only services.

The manufacturer could require further pieces of information to enable them to identify the sales of the product – ISIN, flows, AUM, Units, along with full details of the end distributor and the names of other distributors in the chain. A data set has been proposed, see Appendix A, though it is up to each firm to determine the level of information they need to assist them with their product governance obligations.

A manufacture could take a proportionate approach to the quantity and frequency of Sales MI for example, where a firm is manufacturing mass market non-complex retail products the manufacturer could rely upon the existing level of information it receives from its distributors to support its product governance obligations. For complex products that

have a more restrictive distribution channel it would be sound practice to request more detailed information, as suggested by the data proposal in this Best Practice Paper.

Where manufacturers are already receiving information from distributors it would be sensible to align their MiFID II MI requests to existing frequency schedules, as firms are likely to processes in place today to process this data.

8.11 Roles & responsibilities of Distributors

End distributor responsibilities

The end distributor has a responsibility to define the target market for the products and services they distribute. They must ensure that the products being distributed meet their own target market definition. The end distributor should make available target market criteria to the end investor.

Where the client is an execution only client the distributor can rely on the manufacturers target market and the client understanding what they are buying, subject to the manufacturer taking appropriate steps to ensure that the product is suited to such distribution. However, there is still some responsibility on the execution only distributor to ensure explicitly incompatible products are not made available to retail clients. For example, a product with a target market defined as only suitable for professional clients or for advised distribution only should not be readily available to execution only retail clients without adequate controls in place.

Distributors must undertake suitability assessments in relation to the product and services they recommend to consumers, and appropriateness tests in relation to complex products they offer execution only.

The end distributor must pass sales information to the manufacturer, or the intermediate distributor, in order for the manufacturer review the alignment sales to the expected distribution strategy and client type. If the distributor does not agree with the target market provided by the manufacturer this should be fed back to the manufacturer.

Intermediate distributor responsibilities

The intermediate distributor must make available the target market criteria to the next distributor in the chain, and must enable the manufacturer to obtain management information from the end distributor in order for them to assess their products. If the intermediate

distributor is manufacturing products i.e. creating wrapped products then they assume the responsibilities of the manufacturer.

Other pieces of data

The manufacturer may request that the distributer forward information in relation to complaints received in respect of the manufacturer's service or products. The manufacturer will not require complaints that have been made in respect of the distributor's products or services.

8.12 Materialization of a crucial event

Should a crucial event materialize, product manufacturers should consider what action, if any, they should take in order to address the risk and mitigate the risk of investor detriment, such as, for example:

a) The provision of any relevant information on the event and its consequences on the financial instrument to the clients or the distributors of the financial instrument if the investment firm does not offer or sell the financial instrument directly to clients;
b) Stopping further issuance of the financial instrument;
c) Changing the financial instrument to avoid unfair contract terms;
d) Considering whether the sales channel through which the financial instruments are sold are appropriate where firms become aware that the financial instrument is not being sold as envisaged;
e) Contacting the distributor to discuss a modification of the distribution process; or
f) Informing the relevant competent authority[63]

Good practice includes fully documenting the considerations taken into account in the decision-making process and what actions if any should be implemented, including a review of the product approval process. Actions should be tracked to ensure they are completed and should be completed on a timely basis.

8.13 Significant adaptations

Summary of requirements

[63] Commission Delegated Directive 7.4.2016 Article 9(15)

As previously noted, the Directive's product governance rules apply not only to new products but also to significant adaptations of existing products before they are marketed and distributed to clients[64].

While significant adaptations to existing financial instruments are not explicitly defined within the Directive, firms should adopt a sufficiently robust approach to this in terms of defining what constitutes a significant adaptation and what does not and consequently the types of changes to products that would lead to a product needing to be re-approved and through which governance process. It is for firms to decide where the boundaries lie taking into account their business models and the types of product they manufacture.

Good practice guidance

However, as good practice, a firm's arrangements should be designed to avoid 'product creep' and should not be capable of circumventing or undermining the robustness of the overarching product governance process. Some examples of what could constitute a significant adaptation of a product includes (but is not limited to):

- Change of investment objective and/or policy;
- Changes which impact the nature of the investment e.g. use of additional instruments/asset classes, broader use of derivatives, extension/change to product investment remit, extension or reduction of investment restrictions
- Change to risk/return profile
- Change of a benchmark
- Changes in payout profile
- Changes to costs/fees (in particular structural or increases)
- Changes to the liquidity profile;
- Any other change (or combinations of changes) that firms classify as significant

If a product changes during its lifecycle, firms should also consider whether the change is such that they need to notify the distributor (where relevant) and/or the end investor[65]

8. Management Information and Reporting – ongoing assessment

[64] MiFID II Article 16(3) sub para (2)

[65] For some products, such as UK Authorised Funds, there are requirements in relation to when and how an investor needs to be notified of any product changes. Broadly, these fall into three categories: fundamental change – such as a change to the purpose or nature of the scheme; significant change – such as a change in the method of price publication; and a notifiable change – such as a change of the named investment manager

Summary of requirements

Under MiFID II the management body must have adequate access to information and documents which are needed to oversee and monitor management decision making[66]

In relation to product governance, there are specific requirements for the management body to receive information about the financial instruments manufactured by the firm, including information on the distribution strategy for product manufacturers[67], which must be to be systematically included in the compliance reports to the management body. Those reports must be made available to competent authorities on request.

Good practice guidance

Management Information covers a broad range of reporting. However, it should not just be numbers (quantitative) but should also aim to provide a qualitative perspective of how the firm is achieving (or not achieving) good investor outcomes (perhaps through the use of commentary).

Good Management Information should enable management to make good decisions. As good practice, in order to achieve this, Management Information should be for example:

- Accurate – accurate numbers with any qualitative overlay being provided by relevant people;
- Timely – available in sufficient time for managers to act effectively;
- Relevant – clearly setting out what the manager needs to know to enable them to quickly ascertain whether this is within their direct influence or whether this is something they need to escalate;
- Consistent – consistent on a period to period basis to enable managers to identify trends and issues and help them to make sound decisions.

As a good practice principle, Management Information should demonstrate success rather than failures. As such firms should determine specific success criteria and measures to assess themselves against this throughout the product lifecycle.

Another important factor with Management Information is that firms should be able to evidence that the Management Information is being used by the right people and in the right way.

[66] MiFID II Article 9(3) last para
[67] Commission Delegated Directive 7.4.2016 Article 9(6)

Importantly, Management Information should be used to improve and enhance existing systems and processes and to prevent the re-occurrence of errors.

Glossary

For the purposes of the Directive, the following definitions apply:

Ancillary services: means any of the services listed in Section B of Annex I of MiFID II

Durable medium: means any instrument which:

(a) enables a client to store information addressed personally to that client in a way accessible for future reference and for a period of time adequate for the purposes of the information; and
(b) Allows the unchanged reproduction of the information stored

Financial instrument: means those instruments specified in Section C of Annex 1 of MiFID II

Investment firm: means any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis.

Investment services and activities: means any of the services and activities listed in Section A of Annex I of MiFID II relating to any financial instrument within the scope of MiFID

Management body: means the body or bodies of an investment firm which are appointed in accordance with national law, which are empowered to set the entity's strategy, objectives and overall direction, and which oversee and monitor management decision-making and include persons who effectively direct the business of the entity

Product manufacturer: means an investment firm that creates, develops, issues and/or designs financial instruments, including when advising corporate issuers on the launch of new financial instruments[68]

Senior management: means natural persons who exercise executive functions within an investment firm and who are responsible, and accountable to the management body, for the day-

[68] Commission Delegated Directive 7.4.2016 Recital 15 and Article 9(1)

to-day management of the entity, including for the implementation of policies concerning the distribution of services and products to clients by the firm and its personnel

Structured deposit: means a deposit as defined in point (c) of Article 2(1) of the Directive on deposit guarantee schemes, which is fully payable at maturity on terms under which interest or a premium will be paid or is at risk, according to a formula involving factors such as:

(a) an index or combination of indices, excluding variable rate deposits whose return is directly linked to an interest rate index such as Euribor or Libor;
(b) a financial instrument or combination of financial instruments;
(c) a commodity or combination of commodities or other physical or non-physical non-fungible assets; or
(d) a foreign exchange rate or combination of foreign exchange rates

Third country firm: means a firm that would be a credit institution providing investment services or performing investment activities or an investment firm if its head office or registered office were located within the Union

Appendices

APPENDIX 1

Noted below is a non-exhaustive list of product-related management information which could be used to measure a product's behaviour:

Complaints

While individual monthly complaints statistics are useful, trend information (e.g. rolling 12 month figures) can be more informative in highlighting underlying issues with specific products. Data can be assessed in absolute terms but also set against the product manufacturer's general complaints experience. Trend analysis can also be used to identify where more granular root cause analysis may be appropriate. Classification of complaints into the FCA-required categories also enables trend analysis of complaints types across multiple products and may inform the product manufacturer about potential systemic issues related to more than one product (e.g. Administration weaknesses; deficiencies in product disclosure/marketing materials).

Investment Performance

This is an obvious measure used by investors and distributors to gauge the consumer outcomes of a product. Gathering and assessing data on performance/returns is therefore a fundamental key performance indicator in measuring the behaviour and 'success' of a product. While dependent on the individual product type/structure and its return/risk profile and investment horizon, it may be appropriate to consider:

- performance over pre-determined/relevant time periods, e.g. 1 year, 3 years, 5 years, since launch/issue;
- performance against the relevant benchmark or index and/or against a relevant sector or group of competitor products (e.g. quartile in the assigned IA sector);
- performance against any pre-determined/contractual threshold at which the return profile of the product will change significantly and whether this will be to the detriment of consumers' expectations.

Flows

The size of flows in to or out of a product are likely to be informative. Product manufacturers might set thresholds outwith which flow trends are highlighted as warranting greater scrutiny. Unexpectedly high outflows/exits may suggest consumer dissatisfaction or misunderstanding; conversely, unexpectedly high inflows could potentially suggest that the product is not being sold to the correct target market, or is being promoted outside the distribution plan agreed for the product, or that the marketing material is flawed.

Assets under Management

Linked to flows, AuM in a product may be important for on-going product monitoring, for example:

- critical mass - is the product commercially viable and/or is the product strategy able to be properly pursued as described in marketing/disclosure materials at lower than anticipated AuM?
- capacity - has the product attracted greater than expected inflows such that its pursuit of the product strategy may be compromised?
- trends - is the AuM reasonably stable/static over time or does the trend suggest that investors are deserting the product or that longer-term performance/returns are poor and causing the AuM to decline or a combination of the two factors.

Investor Concentration/Asset liquidity

It may be useful to consider the investor base of a product for potential issues, for example:

- is there a large/dominant investor with disproportionate influence over the product?
- are any substantial investors independent of or affiliated with the product manufacturer?
- if affiliated, are there any conflicts of interest and are they appropriately managed?

- how does a large investor's position (and ability to exit the product) reconcile with the liquidity of the product and its assets; would the product or other investors in it be materially affected should the large investor exit the product?

Product change

It may be relevant to capture whether a product has undergone significant change (e.g. within the last 12 months), such as:

- a change to the investment strategy/objective;
- a change of portfolio manager;
- fee/charges amendments;
- revision of the distribution/marketing strategy.

Breaches/events

The number and nature of breaches/events (and near misses) recorded against a product may also be considered a relevant KPI to factor into a product's behavioural score or RAG rating.

Detailed Product Reviews

For those products within a product manufacturer's range which generate a behavioural score or RAG rating of concern, the manufacturer may wish to undertake a more detailed review of a product.

Such reviews might involve analysing in more depth the data sitting beneath the KPIs which have contributed to a RAG rating of concern. In addition, there may be other aspects of a product which such a review could assess to understand better the causes and drivers of the product potentially behaving in an unexpected manner and delivering inappropriate outcomes for consumers, for example:

- analysis of the investment risk profile/VaR/tracking error of the product;

- detailed analysis of the investor base of the product against the designated target market (possibly including reviewing any consumer research undertaken pre/post-launch of the product);
- marketing/campaign/distributor activity in relation to the product and whether this reconciles with (i) the product's strategy/objective, (ii) the product's designated target market and (iii) the distribution plan for the product at launch (including for older products potentially launched under earlier regulatory/disclosure regimes, where there may be no target market defined or a product may have gone through periods where it was not actively promoted);
- derivatives or gearing/leverage use by the product;
- fees/charges/costs comparison with competing products (potentially also cross-referencing with investment returns achieved by the product and those competitor products).

Reporting/escalation

Good practice would also suggest that the results of the product behavioural scoring or RAG rating, and the findings of any detailed products reviews, are reported to appropriate oversight bodies within the product manufacturer (e.g. customer/conduct committee, executive board, Management Company/ACD). Documented escalation processes for significant issues/findings would also seem a prudent step to provide clarity around oversight and governance responsibility for existing products.