



# MiFID II/MiFIR for Capital Markets

Product Governance, Conflicts of Interest and Order execution in the Primary Market

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**C L I F F O R D**  
**C H A N C E**



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# Overview: MiFID II & Developing Financial Products

- Based on General Duty to Act in Client's Best Interests
- Internal Presale Approval and Review Process (PARP): Article 16(3), 24(2) MiFID 2
  - Defining target customers (retail and / or professional)
  - Risk analysis for the target group
  - Assess needs and risk appetite for the target group
  - Distribution strategy consistent with the target group
  - To protect both retail and professional clients
- Apply to:
  - Investment firms that produce financial instruments (e.g. as Issuers) or develop financial services
  - Regulated distributors of financial instruments (e.g. brokers, platforms). Not to regulated markets
- Manufacturer:
  - Provides information to the distributors about products, PARP and target market
  - Ensures that product reaches the target market
  - Regular review of performance
- Distributors:
  - Perform their own PARP and check against target market data
  - Reports to manufacturer
  - Cannot offer outside the target group
  - Suitability/appropriateness tests apply to final client sales/advice
  - Execution-only platforms are also distributors

Relevant Articles:  
art. 16+24 MiFID 2  
Chapter III Draft EC  
Delegated Directive

# Who, What and Where? (1)

- **To whom do the provisions apply?**

- Manufacturers:** Level 1: Investment firms\* that develop financial instruments to sell to clients  
Level 2: Investment firms\* that create, develop, issue and/or design investment products. Includes firms advising non-regulated issuers on new securities issues.
- Distributors:** Level 1: Investment firms\* that offer or recommend investment products and services (eg fund platforms) to clients  
Level 2: essentially any investment service provided to an investor (even if ‘execution only’). So includes advisors, platforms and other intermediaries. How about independent advisors?

- **No direct application to:**

- (i) life assurance products; or
- (ii) AIFMs or UCITS management companies when carrying out the management or marketing of an AIF or UCITS for which they act as manager.

\* **“Investment Firms”** – any legal person whose regular occupation or business is the provision of one or more investment services (or performance of investment activities) on a professional basis. Includes banks.

Relevant source:  
ESMA Level 2 Technical Advice  
Chapter III Draft EC Delegated Directive

# Who, What and Where? (2)

## ▪ What products are captured?

- All financial instruments, so includes shares and bonds
- All investment services
- Modifications of existing products
- Structured deposits (art. 1(4) MiFID2)
- Primary market products such as stocks and bonds
- Secondary market products (repacks)
- What about investment strategies?

## ▪ Where do the provisions apply?

All manufacturers, distributors and intermediaries doing business inside the EEA

Manufacturers, distributors and intermediaries doing business outside the EEA still captured if EEA based manufacturers and distributors require information from them to comply with rules applicable to them

Relevant source:  
ESMA Level 2 Technical Advice  
Chapter III Draft EC Delegated Directive

# Obligations on manufacturers and distributors

## Manufacturer

- Operate and review a PARP
- Identify potential target market of end clients for each product / service
- Products designed to meet the needs of target market (verify)
- Complete a conflicts of interest analysis for each product
- Governance processes for effective oversight and control (role of management and compliance)
- No threat to integrity or stability of financial markets
- Assess poor investor outcomes (scenario tests)
- Consider the charging structure and the impact on outcomes for target market\*
- Regular review of the performance and distribution of investment products (check if product functions as intended) and if necessary take action
- Use appropriate distribution channels
- Make available to distributors all appropriate information on the PARP for each product, including target market and the required service level (advice-only / execution-only)

\* Charges should not undermine the return expectations of the product

\*\* Record sales activities to demonstrate compatibility

## Distributor

- Receive from manufacturer information about its PARP and the target market to understand design and target market. Pass on to the next distributor
- Independently check if product meets the needs of the target market (using own client information)
- Governance processes for effective oversight and control (role of management and compliance)
- Distribution strategy (products and services) must be compatible with (needs of) target market (regular review)\*\*
- Provide information to manufacturers to assist with post-sale governance / manufacturers' review of products
- For third country or non-MiFID manufacturers: receive reliable and adequate information from manufacturer to ensure distribution in accordance with needs of target market. Distributor to perform all manufacturer's duties. So: conflicts analysis in securities underwriting situations (can it place with own clients?)

[Relevant Articles:](#)  
Articles 16/24 MiFID 2  
Chapter III Draft EC  
Delegated Directive

# Issues to consider

## Scenario Testing: what is risk of “poor investor outcomes”?

- “What if” test, will the result still be acceptable for target market in case of:
  - stressed market conditions / next financial crisis
  - a producer or other participant (benchmark provider / swap counterparty / 3<sup>rd</sup> party guarantor) has financial problems
  - poor or excessive demand for the product
  - change in tax law
- Benefits
  - ensure all relevant risks are identified and assessed both on an initial and on-going basis
  - establish how the product will perform under a variety of conditions, including possible failures of design features
  - understand the inter-actions of different product characteristics and assumptions built into the product design process
  - model potential product outcomes from an investor/customer perspective
  - can help to inform approach to use of risk warnings
  - make decisions that better integrate risk management
  - improve contingency planning and develop appropriate mitigating actions before events crystallise
  - can help prevent liquidity and/or capacity constraints
  - allows identification of crucial events as required under MiFID II

## Target Market

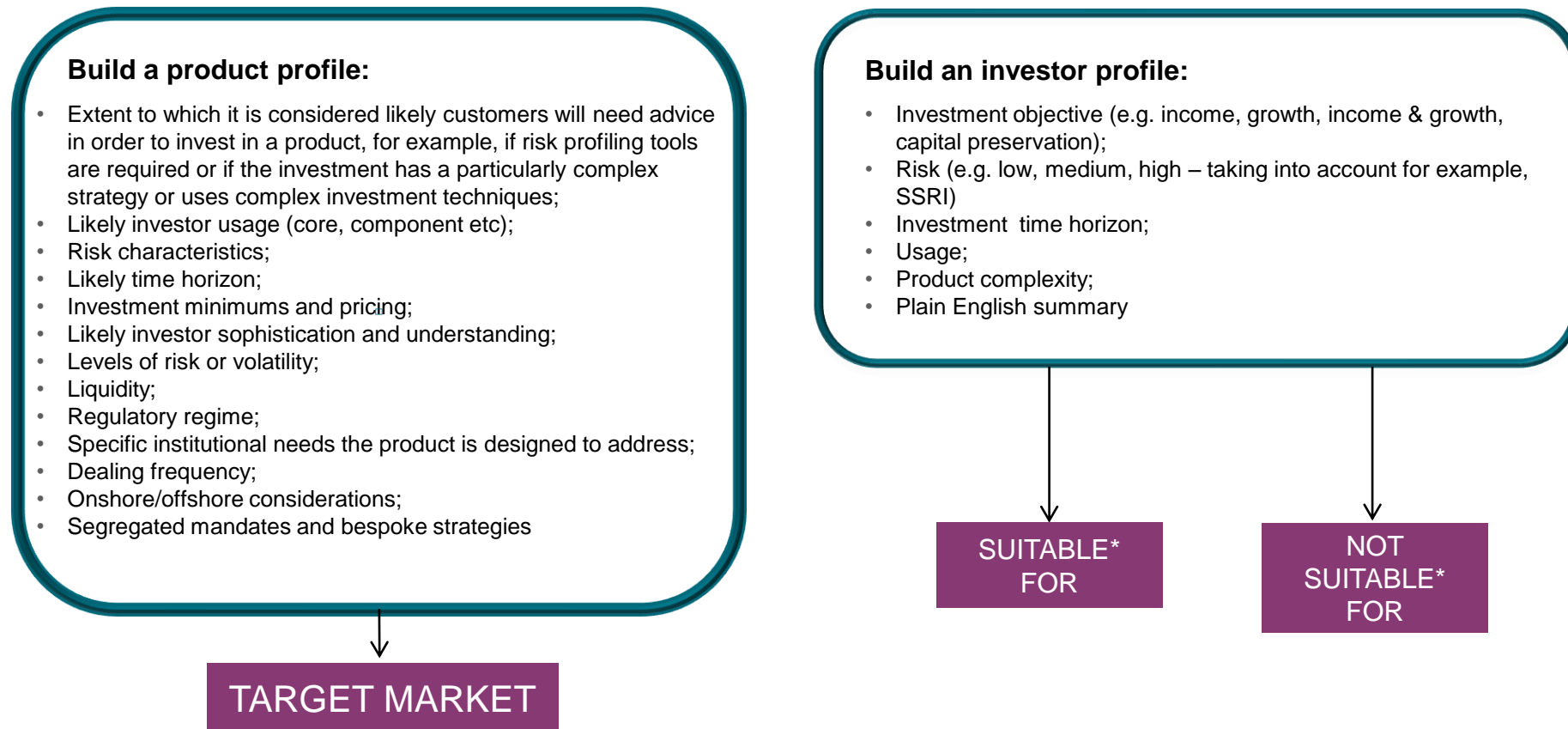
- Who determines target market if more parties distribute similar products?
- Can the target market differ per country in international distribution?

## Controlling the distribution channel:

- Check if product only sold to target market.
- In case of substantial sales outside target market:
  - Talk to distributor
  - Terminate distributor
  - Inform AFM
  - Adjust target market (if justifiable)

# Identifying a target market – some common approaches

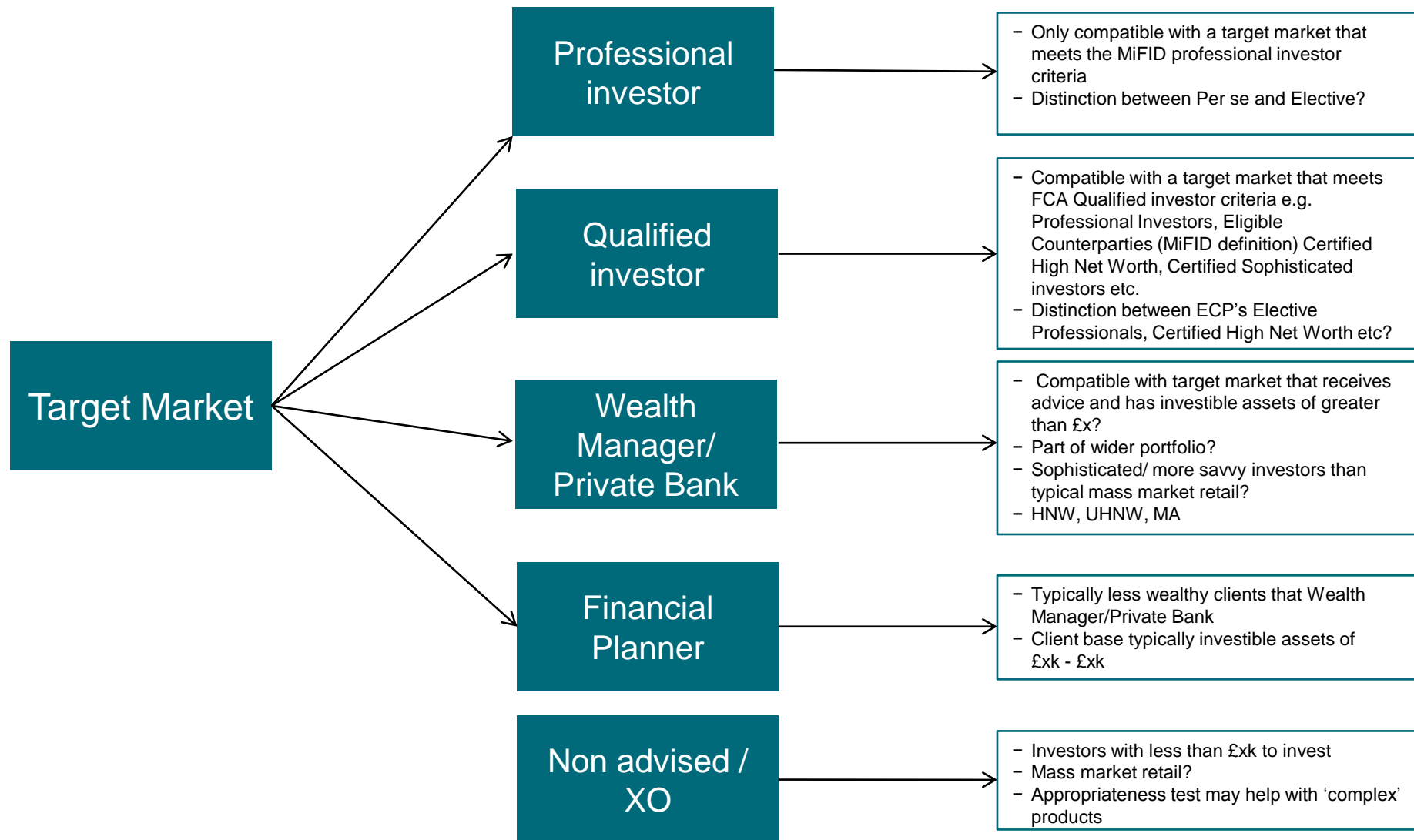
Typically, firms approach the identification of a target market through building either a product profile or an investor profile:



\* MiFID II uses the term compatible



# Can we use target market definitions to Build an end investor profile?



# Product Intervention Powers: National Level

## National Competent Authorities:

May prohibit or restrict:

- (1) The marketing, distribution or sale of certain financial investments or structured deposits with specific features or
- (2) A type of financial activity or practice.

Prohibition or restriction may be on a precautionary basis prior to marketing, distribution or sale (art. 42(2) MiFIR).

## Grounds:

- Investor protection concerns: no or inadequate product governance
- Posing of a threat to the orderly functioning and integrity of the financial markets or stability of the whole/part of the financial system
- Existing EU regulatory requirements insufficient to address risks and issue not better addressed by improving existing supervision or enforcement requirements
- Action is proportionate to risks, investor/market participant sophistication and likely effect of action
- NCA has properly consulted other NCAs who may be significantly affected
- Action has no discriminatory effect on services/activities provided from another Member State.

## Timing

- One month notice to other NCAs + ESMA unless exceptional cases apply (urgent action can be taken on 24 hours notice to NCA's + ESMA for no more than 3 months)
- Temporary ban or restriction can only last up to three months, but can be renewed after review

Relevant Articles:  
Article 40-42 MiFIR / Article 69(2) MiFID II  
Chapter V Draft EC Delegated Directive

# Product Intervention Powers: EU Level

## ESMA and EBA:

Must ensure action taken by NCAs is justified and proportionate and a consistent approach is taken.

May also prohibit or restrict:

- (1) The marketing, distribution or sale of certain products or products with specific features or
- (2) A type of financial activity or practice.

Prohibition or restriction may be on a precautionary basis prior to marketing, distribution or sale.

Actions prevail over those taken by NCAs.

BUT must ensure action does not:

- have a detrimental effect on efficiency of markets on investors that is disproportionate to benefits; and
- create a risk of regulatory arbitrage

Grounds:

- Investor protection concerns
- Posing of a threat to the orderly functioning and integrity of the financial markets or stability of the whole/part of the financial system
- Existing EU regulatory requirements insufficient to address risks and issue not better addressed by improving existing supervision or enforcement requirements
- NCA(s) have taken no or inadequate actions

Timing

- Requirement to notify NCAs before taking action
- Prohibitions or restrictions must be reviewed at least every 3 months and will expire after 3 months if not renewed.

Relevant Articles:  
Article 40, 41 & 42 MiFIR  
Chapter V Draft EC  
Delegated Directive

# Conflicts of interest: general requirements

- No substantive changes between MiFID1 and MiFID2 Level 2.
- Primary obligation: effective organisational arrangements to prevent conflicts of interest from arising in the first place or from adversely affecting clients.
- Failing that: adequate disclosure to clients.
- ESMA Level 2:
  - disclosure must include a statement that the firm's organisational and administrative measures are sufficient to prevent risk of damage to client interests;
  - disclosure must take into account the nature of the client receiving it and be in a durable medium, regardless of the client's categorisation;
  - disclosure must include a specific description of the conflict as well as the risks it engenders for the specific client/service category to enable the client to take an informed decision whether or not to proceed;
  - conflicts policies must be reviewed at least annually (to address deficiencies); and
  - overreliance on disclosure is a deficiency.
- Applies to all clients

[Relevant Articles:](#)  
Article 16(3) + 23 MiFID 2

# Conflicts of Interest / Analysts

- ESMA in Technical Advice:
  - suggested that “marketing communications” and those who produce them should be subject to Art 25(1) of the Implementing Directive. This would result in firms effecting measures designed to ensure an appropriate level of independence for those producing marketing communications that come within the definition of recommendations in Directive 2003/125/EC.
  - recommended the physical separation of “analysts” from those whose responsibilities or business interests may conflict with the interests of the recipients of the advisors’ research.
  
- EC Delegated Regulation: analysts and producers of ‘marcons’ behind Chinese walls / info barriers to sales staff
  - Separate supervision
  - Removal of remuneration incentives
  
- EC Delegated Regulation: analysts to be physically separated from other business units\*:
  - Trading ban (personal and firm)
  - No inducements to firm or analysts
  - No favourable research coverage to issuers

\* Firms may, on proportionality grounds, establish “appropriate alternative information barriers”.

[Relevant Articles:](#)  
[Articles 37-38 draft](#)  
[Delegated Regulation](#)

# Conflicts of Interest / Underwriting and Placing (1)

## ESMA:

- **Significant potential for conflicts of interest in the underwriting and placing process;**
- **Proposes that the following organisational arrangements and/or provision of information requirements shall be placed on firms:**

### Advising to undertake an offering

Where the firm is advising the corporate finance strategy and providing the service of underwriting and placing, the firm must explain certain information to the issuer, before accepting the mandate, eg the financing alternatives and fees and details of the targeted investors.

### Pricing

- Have in place systems, controls and procedures to identify and manage conflicts that arise in relation to possible under-pricing and over-pricing of issues and involvement of relevant parties in this process, including book-buildin
- Provide clients with information about how the firm determines its recommendation as to the price of the offering and the timings involved, specifically information on any hedging or stabilisation strategies and how the pricing may develop during the offer process.

### Placing

- Prevent placing recommendations from being inappropriately influenced by any existing or future relationships.
- Have in place internal arrangements that manage or prevent situations where those persons providing services are involved directly in decisions about recommendations to the issuer client on allocation.
- Have an allocation policy that sets out the process for developing allocation recommendations, which they must disclose to and discuss with the issuer.
- Not accept third party payments in conflict with the conditions of the MiFID II inducements regulations.
- Invite issuer clients to participate in discussions about the placing process, so that their interests can be accounted for.

# Conflicts of Interest / Underwriting and Placing (2)

## **Retail advice/distribution:**

- Manage conflicts where the firm provides investment services to a client to participate in a new issue for which it receives arranger commissions or fees.
- When placing its own/group financial instruments to its own clients, identify and manage potential conflicts of interest and refrain from the activity if they cannot be appropriately managed.
- When disclosing conflicts of interests, enable clients to make an informed investment decision by explaining the nature and source of such conflicts and details of specific risks.
- When offering their own/group financial instruments, which are included in the calculation of prudential requirements, explain the differences between these and bank deposits (eg yield, risk, liquidity and protections).

## **Lending/provision of credit:**

- Identify and manage any conflicts of interest arising when the proceeds of an issue are used to repay a loan.
- If insufficient steps were taken to prevent damage to the client, disclose any specific conflicts of interest that arose in relation to the firm (or a group entity) acting in the capacity of both credit provider and arranger.
- Where group entities act as credit provider and arranger for the offering, have a conflict of interest policy which requires full sharing of information in relation to the issuer's financial situation (maintaining information barriers).

## **Record-keeping**

- Content and timing of instructions received from clients
- Allocation decisions taken for each operation.

## **Oversight**

- A centralised process should identify all underwriting and placing operations and keep a record of this information.
- Identify all potential conflicts of interests arising from other activities of the firm or its group and implement appropriate management procedures. In some cases if management is not possible, the firm should not engage in the operation.

# Self-placement of own financial instruments = execution of orders for clients

- Extended definition of “order execution on behalf of a client” includes direct issuance of instruments by firm/bank.
- If an investment firm or bank distributes its own financial instruments at the moment of issuance without providing any advice, such service should also be covered by MiFID II, according to recital (45). This is achieved by extending the definition of “execution of orders on behalf of clients” to this effect (article 4(1)(5) MiFID II).
- Does this mean that an investment firm / bank acting as issuer in the primary market would at all times also be deemed to provide order execution services to any subscriber? Or should there be a pre-existing client relationship?
- The investor protection idea is that investors dealing with an authorised institution might reasonably expect their activities to be regulated when selling their own securities as well as when selling the securities of third parties.
- Results:
  - extra license needed?
  - client relationship with all primary market investors?
- Enhanced investor protection. But how much?
  - appropriateness test to be applied unless excluded instruments
  - best execution duty applies?
  - conflicts of interest rules apply
- Applicable to primary market for own instruments
  - how long?
  - private placements / reverse enquiries?
  - shares/bonds only or also OTC derivatives?
- Not applicable to repurchase of own securities

[Relevant Article](#)  
Article 4 and 25 MiFID2



# “Execution only”

- Scope for X-only without appropriateness test narrowed:
  - shares/bonds traded on RM / MTF / TCEV;
  - shares or units in UCITS;
  - structured deposits.
- Appropriateness test required for X-only in respect of:
  - shares/bonds not traded on RM / MTF / TCEV;
  - UCITS with KiiD longer than 3 pages and structured UCITS;
  - non-UCITS collective investment schemes / AIF’s;
  - any financial instrument if combined with credit;
  - shares/bonds/MMF’s ‘that embed a derivative’;
  - complex debt instruments (difficult to understand for client);
  - securitisation products;
  - complex structured deposits (difficult to understand for client).
- Client warned on absence of appropriateness test.
- Applies to retail and professional clients (but not ECP)

Relevant article:  
article 25 and 30 MiFID 2