

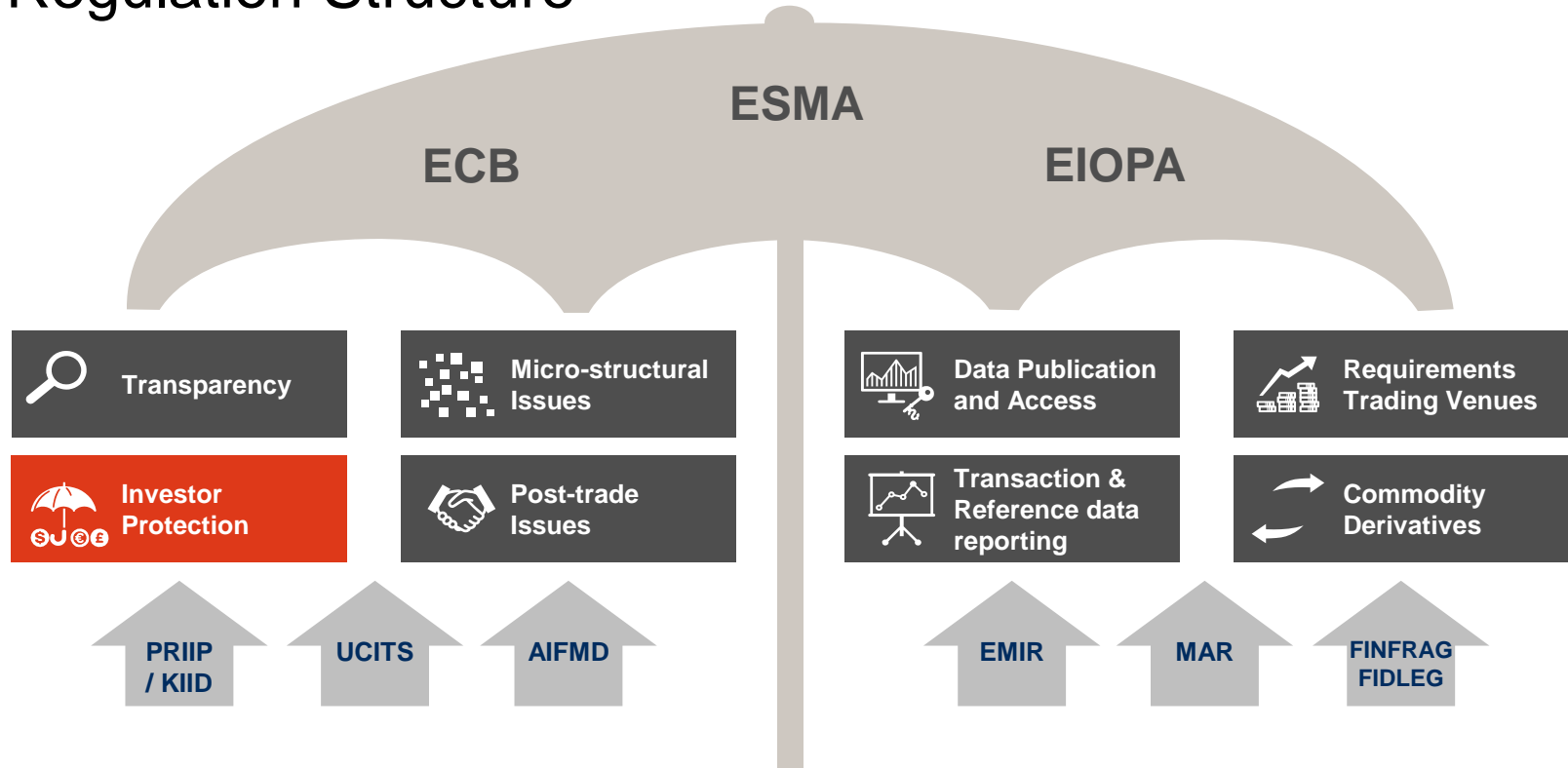
MiFID II: New challenges in the area of Product Governance

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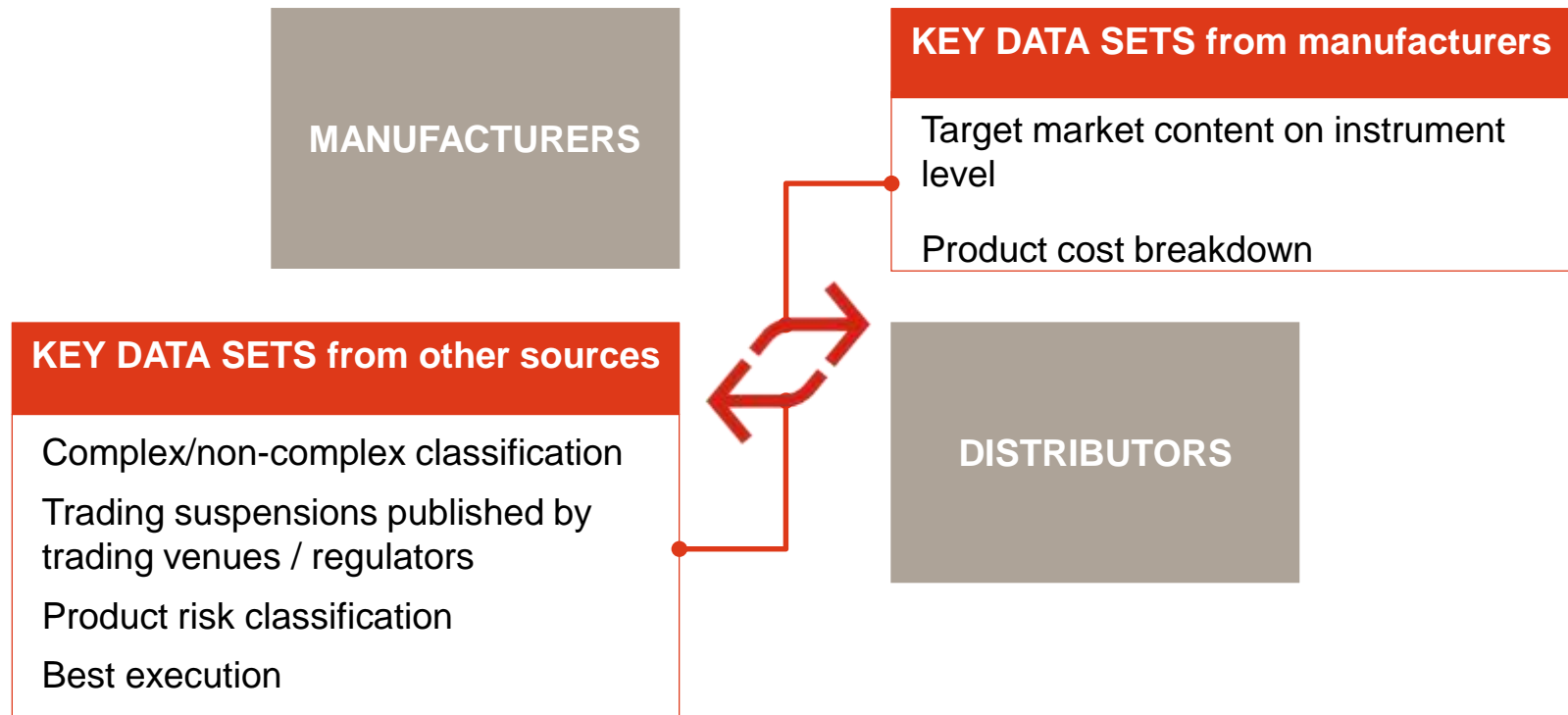


MARKET DRIVERS

Regulation Structure



Advisory must ensure that retail investors are only offered investment products suitable to their “risk appetite”



MiFID II seeks a standard form for information exchange between Manufacturers & Distributors

MANUFACTURERS

Required to maintain, operate and review **product approval process** for each financial instrument before it is marketed or distributed to clients

Required to **identify a target market** for each product i.e. which type of person is it suitable for?

DISTRIBUTORS

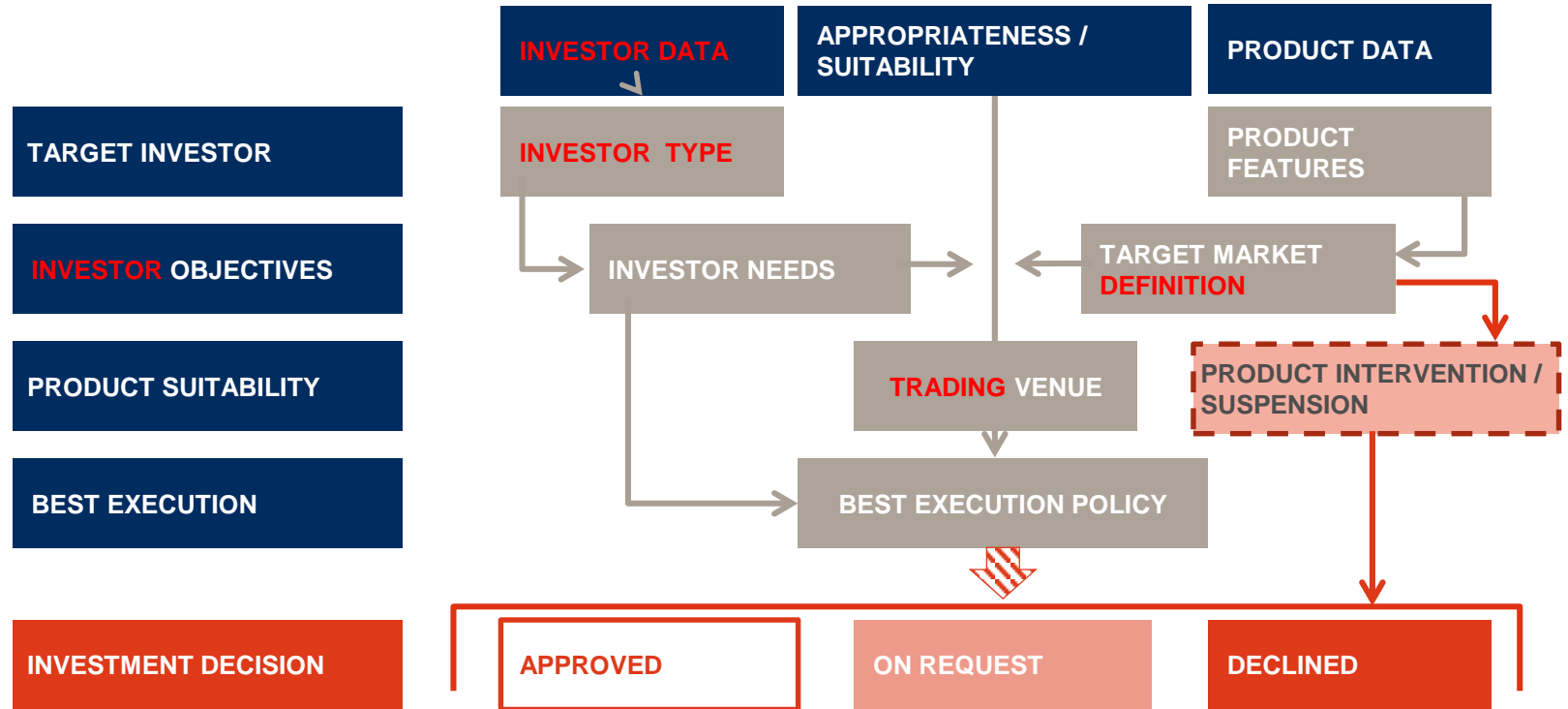
Required to adhere to the **target market defined** for each investment product

Make arrangements to obtain **all appropriate information** on the product

Products must be compatible with the **needs, objectives and “risk appetite”** of the investor



How investment advisory works in practice under MiFID II



All costs & charges have to be disclosed throughout the product lifecycle

- All internal and external costs and charges for the investment services and/or ancillary services provided to the client must be disclosed inclusive -
- All Costs associated with the manufacturing and managing of the financial instruments;

+ **costs will play an integral role in any product governance rules** that limit access to the full range of products, both for investors and distributors.

SIX service package to support compliance with guidelines related to Investor Protection

- Complex/non-complex classification
- Target market content on instrument level
- Product risk classifications
- Cost breakdown
- Leveraged instrument marker
- Best trading venue
- Trading suspensions published by trading venues

Regulatory Way: Supports bi-directional communication required under ESMA's CP 2016/1436

Regular review by the manufacturer and distributor to respectively assess whether products and services are reaching the target market

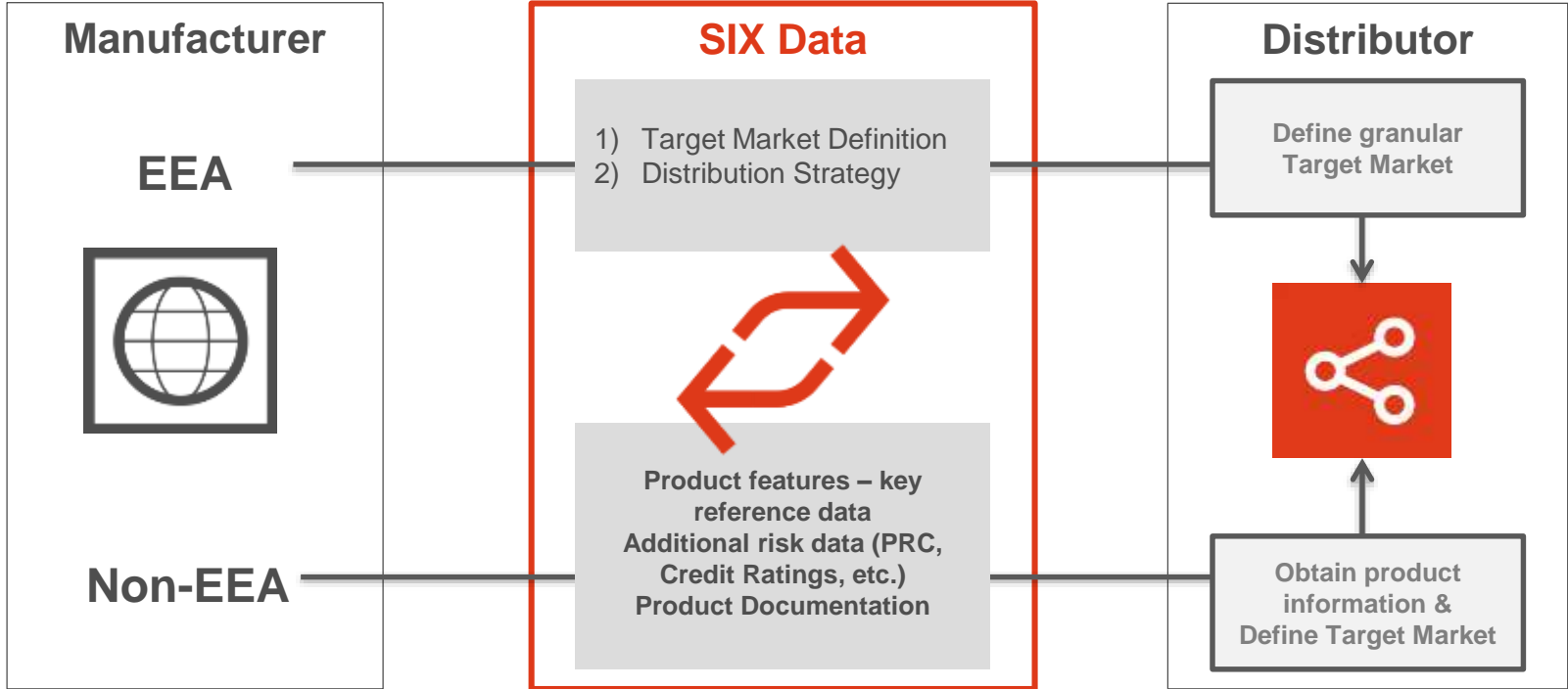
47. MiFID II¹⁸ require firms to review products on a regular basis to assess whether the product remains consistent with the needs, characteristics and objectives of the identified target market and whether the intended distribution strategy remains appropriate. The same requirements apply to distributors in relation to services offered.
48. Manufacturers should consider, on a proportionate basis, what information they need in order to complete their review and how to gather that information. In line with recital 20 MiFID II Delegated Directive, relevant information could include, for example, information on which distribution channels have been employed, the proportion of sales made outside the target market, summary information of the types of client, a summary of any complaints received and questions suggested by the manufacturer to a sample of clients for feedback. Such information may be in an aggregated form and does not need to be on an instrument-by-instrument or sales-by-sales basis.
49. To support reviews by MiFID manufacturers, distributors **must** provide them with information on sales and, where appropriate, any other relevant information that may be the outcome of the distributor's own periodic review. Furthermore, distributors should consider data and information that may give an indication that they have wrongly identified the target market for a specific product or service or that the product or service no longer meets the circumstances of the identified target market, such as where the product becomes illiquid or very volatile due to market changes.
50. In relation to the **obligation** on distributors to report information on sales outside the manufacturer's target market, distributors should be able to report any decisions they have taken to broaden the target market or the distribution strategy from the ones recommended by the manufacturer and information on sales made outside the target market/distribution strategy (including sales within the negative target market).

Target Market



Target Market Assessment Update

ESMA's CP 2016/1436



Target Market Assessment Open Issues ESMA's CP 2016/1436

Target Market Categories



- Client type
- Knowledge & Experience
- Ability to bear losses
- Risk/Reward Profile
- Clients' Objectives
- Clients' Needs
- Distribution Strategy/Channel

Open Questions



- Will a standard emerge?
- Where will the TM be published?
- How will a change be communicated?
- Who are the issuers?
(i.e. equities, debt, ETDs)

Product Costs



MIFID II Product Cost Requirements

	Description	Examples
One-off charges	entry costs exit costs	distribution fee; IEV; front-end load redemption fee; deferred load
On-going charges	all on-going cost and charges related to the management of the financial product that are deducted from the value of the financial instrument	administration fee; shareholder service fee; management fee; custody fee; KIID Ongoing Charges Figure; TER Total Expense Ratio
All costs related to the transactions	all costs and charges that are incurred as a result of the acquisition and disposal of the instruments	transaction fee (processing fee)
Incidental Costs (performance fees)	performance fee carried interest	performance fee

Complex / Non-Complex Classification



Non-Complex Instruments: Main characteristics according to article 25(4)(a)

Shares	<ul style="list-style-type: none">• admitted to trading on RM, MTF or equivalent third-country market• no embedded derivative
Bonds and other securitized debt	<ul style="list-style-type: none">• admitted to trading on RM, MTF or equivalent third-country market• no embedded derivative or structure which makes it difficult to understand ...
Money-market instruments	<ul style="list-style-type: none">• no embedded derivative or structure which makes it difficult to understand ...
UCITS	<ul style="list-style-type: none">• only non structured
Structured deposits	<ul style="list-style-type: none">• no structure which makes it difficult to understand the risk of return or cost of exiting the product before term;
Other non-complex FI's	<ul style="list-style-type: none">• no embedded derivative or structure which makes it difficult to understand ...

Proprietary rule set for Complex / Non-complex classification

Conditions:
callable,
putable etc.

Interest
conditions:
Variable / fix

Interest
conditions:
UL's used for
fixing of rate

Tradeability:
Listings
(RM, MTF, etc.)

Tradeability: Freq.
of trading
(according to Delegated
Regulation)

50+
Factors

Covering complex/non-complex classification incl. local EEA national “flavors”

	Classification	Implication
Italy & Spain	<ul style="list-style-type: none">• non-complex• complex• very / highly complex	<ul style="list-style-type: none">• classification based on different criteria• Detailed analysis required to create an appropriate rule set
Denmark	<ul style="list-style-type: none">• Danish mortgage backed securities (MBS) are non-complex• all Hedge Fonds are classified as complex	<ul style="list-style-type: none">• implemented under MiFID I, rules will be copied to MiFID II rule set
...		

Product Intervention



Monitoring the regulatory development of product interventions

Regulation



The investor protection elements of MiFIR introduce under Article 40 specific product intervention powers where ESMA and NCA are able to temporarily prohibit or restrict the marketing, distribution or sale of a financial instrument or a type of financial activity or practice

Requirements



- Monitor different sources in different languages for product intervention notifications
- Identify the instruments impacted by the notifications and indicate the respective restrictions

Example: BAFIN

On 28 July 2016, **(4)** BaFin published a draft of its respective product intervention in the form of a General Administrative Act (*Allgemeinverfügung*). The proposed order would ban issuers, companies and persons from **(1) marketing, distributing or selling (2) credit-linked notes (3) to retail investors**. Comments on this draft may be submitted up to 2 September 2016.

- The type of client **(3)**
- The type of product(s) **(2)**
- The type of service (sales, marketing, execution, advisory) **(1)**
- The territorial application - **DE**
- Validity (time from time to) –
(?) 'The General Administrative Act shall be deemed announced on the day following the public announcement.'
- The issuing agency - **(4)**
- Others (incl. link to the official notice) –
[Hearing: General Administrative Act pursuant to section 4b \(1\) of the German Securities Trading Act \(Wertpapierhandelsgesetz – WpHG\) regarding credit-linked notes](#)

Leveraged Instrument



What is a leveraged instrument?

MIFID II

MIFID II doesn't provide a definition; Art 62 (2) requires frequent reporting to clients holding leveraged instruments. Art. 25 (4) and ESMA's Guidelines on complex debt instruments and structured deposits, 04.02.2016

(j) Debt instruments with leverage features. This category includes debt instruments structured in such a way that the return or losses to the investor may occur at multiples to the initial investment
In Delegated Regulation from 25.04.2016, Article 57

(c) ..does not involve any actual or potential liability that exceeds the costs of acquiring the instrument

2016-1444 Q&A on MiFID II Investor Protection Topics from 16.12.2016:

“financial instrument has the potential of magnifying an investor's exposure to an underlying risk then this will result in the instrument being a leveraged financial instrument”

AIFMD

Art 4(1)(v) defines leverage as *“any method by which the AIFM increases the exposure of an AIF it manages whether through borrowing of cash securities, or leverage embedded in derivative positions or by any other means*

UCITS

With UCITS III, the product directive expanded the type of available investments to allow a UCITS to invest in derivatives not only for efficient portfolio management or hedging but for investment purposes as well

Flagging of leveraged instrument

SIX Definition of Leveraged Instrument:

Leverage embedded in a financial instrument is the amount of market (or underlying asset) exposure per unit of committed capital. In other words, an instrument embedded leverage is its percentage change in price for a one percentage change in underlying. It measures the instrument return, profit or loss, relative to the return of the underlying.

Thank you.