Bankers told to lead from the top on Mifid governance rules

Structured products issuers' strategy should reflect new guidelines, say regulators

Esma proposed guidelines [illegible] product governance rules in October

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Senior executives need to set the standards that ensure structured products manufacturers meet tough new guidelines on product governance under the second Markets in Financial Instruments Directive (Mifid II), regulators have warned.

"You should be careful this is not a tick-box exercise. The tone at the top of product governance, which is also linked to the strategic framework of the firm, is crucial," Marc van Efferen, a senior supervisor leading Mifid II consumer protection implementation at the Netherlands Authority for the Financial Markets (AFM), told delegates at the **Structured Products Europe** conference in London on November 17.

The European Securities and Markets Authority (Esma) launched a consultation on Mifid Level 3 guidelines for product governance requirements on October 5. The consultation closes on January 5. The rules will apply to both **product manufacturers and distributors** – the first time there has been such a comprehensive framework in the European Union.

Guillaume Bérard, an adviser at the Belgian Financial Services and Markets Authority in charge of the conduct of business rules, told conference delegates he thought product governance preparations were "well under way" for most industry participants. He echoed van Efferen's emphasis on broad corporate buy-in to the concept, starting at the top.

"It is important to have senior management involved. Senior management should be aware of the type of products that are being sold, the type of issues encountered. It is important to have a clear framework within the firm of the whole process: who is going to be involved, what are the exchanges of information, and avoiding overreliance on some people. It is important also to document the process, to justify why you have done it like this and show adequate controls," Bérard said.

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Guillaume Bérard, Financial Services and Markets Authority, Belgium

The AFM introduced **similar product governance rules** for non-Mifid firms in 2013. Van Efferen said one of the key lessons of the experience was that firms should put governance right at the heart of the business.

"What is this product I am going to sell? Is this a product we as a firm are standing for; do we want our name linked to it? What we see is that successfully applied product governance processes link the strategy of the firm to product governance," he said.

Bérard, who is a member of Esma's Investor Protection and Intermediaries Standing Committee, agreed with this assessment, describing product governance as "a way of thinking". He urged firms to put the client at the heart of both product design and distribution processes in order to instil the philosophy that supervisors would want to see.

"This has all types of consequences. For example, when you are choosing the underlying assets for a product, you need to be sure they match the needs of your potential target market. It also means this is a dynamic process – this is not just a product you are going to launch in the market and after that nothing; you need to think about your customer from day one to the end of the product, and take this into account over time," said Bérard.

Van Efferen pointed out that investor suitability rules in Mifid II would also drive better recording of information on the product design and distribution process from start to finish. This information would include verifying that distributors were selling to the target market identified by the manufacturer.

Tougher rules on conflicts of interest and restrictions on the use of inducements are also key components of Mifid II that will affect structured product manufacturers. Bérard said benchmarking the price of internal hedging or trading solutions against the cost of third-party alternatives was vital to assessing potential conflicts of interest if manufacturers used internal hedging.

"Another basic one is, when you are pricing your products, you should wonder would a professional client buy the product at that price. If the answer is no, then you may have an issue here," said Bérard.

The AFM already introduced a full ban on inducements for retail investors in 2014. The Mifid II rules stop short of an outright ban, but will cover a wider range of client types. Van Efferen said he expected the Netherlands to maintain its ban even after Mifid II enters into force in January 2018, with a 2015 impact study suggesting the policy was well respected among Dutch market participants.

"The cost of execution-only services has declined and, although there was a slight decrease in the number of investors receiving financial advice, that trend was already notable before the ban because institutions were declining to give advice due to the legal risks. Even so, we will monitor the trend closely," van Efferen said.