

## **Chapter 2 – PRODUCT GOVERNANCE**

### *Introduction*

Clients, in particular retail clients, may face difficulties in understanding the risks and returns of certain types of products. Investors may in fact be exposed to unexpected losses unless they are in a position to clearly understand the risk and reward profile of such products by means of a proper assessment of such products against the risk appetite of investors. This may give rise to complaints, reputational risks for product manufacturers and distributors and ultimately to loss of confidence in the regulatory framework, and more broadly, in financial markets. Accordingly, sound product governance arrangements by Regulated Persons manufacturing and/or distributing products are fundamental for investor protection purposes. Furthermore, such arrangements can reduce the need for product intervention actions by the MFSA.

This Chapter is therefore aimed at setting out regulatory requirements applicable to Regulated Persons which manufacture and/or distribute products. In particular, these Rules establish, *inter alia*, the requirements relating to product design, identification of the target market for such products as well as product oversight, namely the policies which Regulated Persons should have in place to ensure that their products continue to be suitable for the target market identified by them. The applicability of these Rules depends on whether a Regulated Person is involved in the manufacturing or distribution of a specific product, or both. Moreover, this Chapter also deals with the information which Product Manufacturers should provide to Product Distributors so that the latter would be in a better position to effectively explain the characteristics of the products concerned, when distributing such products to clients. Furthermore, apart from being required to adhere to Rules applicable to both Product Manufacturers and Product Distributors, Regulated Persons solely concerned with product distribution are also subject to specific Rules, taking into account various factors such as the type of product being distributed and the origin of the Manufacturer on behalf of whom such products are being distributed.

### Application

The Rules and any relative guidance set out under the heading “General Rules” shall apply to Manufacturers and Distributors, unless otherwise indicated.

In addition to the above, Manufacturers and/or Distributors of Structured Products are also required to comply with the rules set out in the Section entitled “*Rules applicable to Manufacturers and Distributors of Structured Products.*”

The Rules and the relative guidance set out in this Chapter shall not apply to Regulated Persons falling under point (iv) of the definition of ‘Regulated Person’ in the Glossary where such Regulated Person is enrolled as an insurance broker and where the subject of the contract of insurance relates to:

- a) The business of reinsurance;
- b) Large risks as defined by Article 5 of the Second Council Directive 88/357/EEC of the 22<sup>nd</sup> June 1988 on the coordination of laws, regulations and administrative provisions relating to direct insurance other than the life assurance and laying down provisions to facilitate the effective exercise of freedom to provide services and amends Directive 73/239/EEC.

### General Rules

- R.2.1 Manufacturers shall ensure that:
- a) They design products to meet the needs of an Identified target market of end clients within the relevant category of clients,
  - b) the strategy of distribution of the products is compatible with the identified target market, and
  - c) they take reasonable steps to ensure that the product is distributed to the identified target market.
- R.2.2 A Distributor shall understand and regularly review the Products it offers or markets, taking into account any event that could materially affect the potential risk to the identified target market, as a minimum, to assess whether the product remains suitable for the identified target market.
- R.2.3 Manufacturers and Distributors shall consider the best interests of the client when designing, valuing and pricing a Product as well as offering a Product;
- G.2.1 *Manufacturers and Distributors shall ensure that Product governance and oversight arrangements do not rely excessively on the judgement and discretion of a limited number of persons but incorporates the effective input of all relevant staff and senior management.*

**Establishment of product governance and oversight arrangements by a Manufacturer**

R.2.4 A Manufacturer shall establish, implement and review Product oversight and governance arrangements. These arrangements shall include a process for the approval of each product and for the approval of any significant adaptations of an existing product, if any, before it is marketed or distributed to clients.

The arrangements referred to in this Rule shall be set out in a written document, endorsed by the Manufacturer's Management Body and made available to all relevant staff.

R.2.5 The Manufacturer's product approval process shall specify an identified target market of clients for each product and shall include measures to be put in place in order to ensure that:

- a) the products are designed to meet the needs of an identified target market,
- b) all relevant risks to such identified target market are assessed,
- c) the intended distribution strategy is consistent with the identified target market
- d) steps are taken to ensure that the product is distributed to the identified target market.

R.2.6 In the case of Financial Instruments, the policies, processes and arrangements referred to in R.2.4 above, shall be without prejudice to all requirements under these Rules and Regulation No 600/2014 (MIFIR), including those relating to disclosure, suitability or appropriateness, identification and management of conflicts of interest, and inducements.

R.2.7 The Product governance and oversight arrangements shall be proportionate to the nature, scale and complexity of the risks inherent to the business of the Manufacturer.

R.2.8 All relevant arrangements and actions taken by the Manufacturer in relation to the Product governance and oversight arrangements shall be duly documented, kept for audit purposes and made available to the MFSA upon request.

**Review of product governance and oversight arrangements by a Manufacturer**

R.2.9 Product governance and oversight arrangements, including the product approval process, shall be regularly reviewed by the Manufacturer to ensure that they are still valid and up to date and amended where appropriate.

G.2.2 *The Manufacturer should consider when to review its product approval process on the basis of the nature of the strategies comprised in the products it manufactures.*

*In particular, the Manufacturer should consider reviewing its product approval process:*

- a) *prior to any re-launch or further issue of the same product;*
- b) *when the Manufacturer becomes aware of any event that could materially affect the potential risk for clients;*
- c) *At regular intervals determined by the manufacturer, based on the product complexity, market conditions, the wider legal and regulatory environment and the needs, characteristics and objectives of the identified target market.*

### **Role of the Manufacturer's Management Body**

- R.2.10 The Management Body of the Manufacturer shall be ultimately responsible for the establishment, implementation, subsequent reviews and continued internal compliance with product oversight and governance arrangements.
- R.2.11 The Management Body of the Manufacturer shall ensure that it has effective control over the Manufacturer's governance process in order to ensure effective oversight and control over the product design and manufacture process. Information about the products manufactured shall be included in compliance reports to the Management Body of the manufacturer and made available to the MFSA on request.

### **Target Market**

- R.2.12 The Manufacturer shall only design and bring to the market, products with features , charges , risks and distribution channels that meet the interests, objectives and characteristics of and are of benefit to the identified target market
- R.2.13 The Manufacturer shall also identify the groups of Clients for which the product is considered unlikely to meet their interests, objectives and characteristics.
- R.2.14 To identify the target market or group of clients, as required in terms of R2.5 and R.2.13, Manufacturers shall consider and assess, *inter alia*, the following:
- a) level of risks of the product to be designed;
  - b) level of risks that the client is willing to bear;
  - c) liquidity accessibility that the client is expected to get;
  - d) understanding of the complexity of the product; or

- e) potential creditworthiness or financial capability of the client;
- f) the level of information available to the identified target market and the degree of financial capability, of the identified target market or group of Clients whose interests, objectives and characteristics, the Product is unlikely to meet.

**Knowledge and ability of staff designing products**

R.2.15 The Manufacturer shall ensure that relevant staff assigned the task to design a product in line with the manufacturer's product oversight and governance arrangements is fit and appropriately trained in order to understand the Product's main features and characteristics as well as the interests, objectives and characteristics of the identified target market.

**Product Design**

R. 2.16 A Manufacturer shall consider the best interest of the clients when designing, valuing and pricing a Product.

R.2.17 When designing a Product a Manufacturer shall ensure that such product meets the needs, objectives, knowledge and experience of the Identified target market.

R.2.18 A Manufacturer shall ensure that the compliance function is involved in the product design process and is entitled to intervene and make appropriate changes, at every stage.

R.2.19 When designing a Product a Manufacturer shall consider the charging structure proposed for the Product, checking, *inter alia*, that:

- i. product costs and other charges are compatible with the needs, objectives and characteristics of the identified target market;
- ii. charges do not undermine the return expectations of the product;, where applicable;
- iii. product design is driven by features that benefit the client and not by a business model that is dependent on poor client outcomes; and
- iv. the charging structure of the product is appropriately transparent for the Identified target market.

R.2.20 Where a Manufacturer collaborates with a third-country manufacturer, based in a non-EEA member state, to create or alter a product, the Manufacturer shall outline the mutual responsibilities of each party in a written agreement.

R.2.21 A Manufacturer shall ensure that appropriate information about a Product is made available to Distributors. This shall include information about the appropriate distribution channels for the product, the product approval process and the

assessment of the identified target market and the group of Clients to whom it does not apply.

### **Management of conflicts of interest in Product Design**

R.2.22 A Manufacturer shall implement and establish procedures to ensure that the design of the Product complies with the requirements relating to the proper management of conflicts of interests.

R.2.23 A Manufacturer shall ensure that an analysis of potential conflicts of interests is conducted each time a product is manufactured. When a Manufacturer develops a product, this should be reviewed to ensure that its design, including the relative features, does not adversely affect clients or lead to problems with market integrity.

### **Outsourcing of the Product Design Process**

R.2.24 A Manufacturer shall retain full responsibility for compliance with the requirements set out in this Chapter regarding product governance and oversight when it designates a third party to design products on its behalf. Outsourcing of product design shall not be undertaken whenever it undermines the continuous and satisfactory service to the identified target market.

### **Product Testing**

R.2.25 Before a Product is brought to the market, is sold to a new identified target market or where changes to an existing Product are introduced, a Manufacturer shall conduct testing of the Product as well as undertake a scenario analysis of its Products. These tests should assess the risks of poor client outcomes posed by the Product and what circumstances might cause these outcomes to occur and whether the scenario's results meet the requirements for the defined target market over the life span of the Product. Manufacturers shall make appropriate product changes where the scenario analysis gives rise to poor results for the identified target market.

R.2.26 A Manufacturer shall ensure that Product tests are conducted in an independent manner and that an audit trail of the results of the testing is kept. These results should be made available upon request to the MFSA.

G.2.3 *For the purposes of R.2.25 above, Manufacturers should assess the Product under negative conditions covering what would happen in certain situations such as if:*

- a) *The market environment deteriorated;*
- b) *The Manufacturer experiences financial difficulty;*
- c) *The Product fails to become commercially viable;*

d) *Demand for the product is much higher than anticipated, putting strain on the Manufacturer's resources or on the dynamics of any underlying product; and*

e) *Counterparty risk materialises.*

R.2.27 A Manufacturer shall review the Products they offer or market on a regular basis, taking into account any event that could materially affect the potential risk to the identified target market.

G.2.4 *For the purposes of the review required in R.2.27 above, the events which should be taken into account include:*

a) *The crossing of a threshold that will affect the return profile of the Product;*

b) *The solvency of certain issuers whose securities or guarantees may impact the performance of the product;*

c) *Other changes in the financial environment that will affect the assumptions used for the design of the Product.*

R.2.28 A Manufacturer shall ensure that it identifies events that could affect the potential risk or return expectations of a Product and, when such an event occurs, the Manufacturer should consider the impact and take appropriate action, including:

a) the provision of any relevant information on the event and its consequences on the Product to the clients, or the Distributors of the Product if the Manufacturer does not offer directly the Product to the clients;

b) changing the product approval process;

c) stopping further issuance of the Product; and

d) changing the characteristics of the Product to avoid unfair contract terms, or consider whether the sales channels for such Product are appropriate, if the Manufacturer becomes aware that the Product is not being sold as envisaged.

### **Product Monitoring**

- R.2.29 Once a Product is distributed, the Manufacturer shall monitor, on an on-going basis, whether the Product continues to meet the interests, objectives and characteristics of the identified target market.
- R.2.30 A Manufacturer shall periodically gather appropriate information as to the performance of the Product so as to improve the design and manufacture of other Products in development.

### **Remedial Action**

- R.2.31 Where the Manufacturer identifies a problem after designing and bringing products to the market or after carrying out product monitoring, it shall take the appropriate action to mitigate the situation and prevent the re-occurrence of the problem.
- R.2.32 The Manufacturer shall notify any remedial action promptly to the Distributor, and to the consumer (in case of direct sales) including changes or modifications to the product. The Manufacturer shall also take any additional actions that need to be taken to remedy the situation to diminish detriment to Clients.
- G.2.5 *Remedial action should be taken when the product no longer meets the general needs of the identified target market or when the product performance is significantly different (in terms of detriment to the client) from what the Manufacturer originally expected.*
- R.2.33 The Manufacturer shall only make changes to the product that are consistent with the interests, objectives and characteristics of the already existing identified target market and these changes do not have an adverse impact on the target market to which the Product has been sold already.

### **Distribution Channels**

- R.2.34 A Manufacturer of Products shall adopt appropriate policies and procedures, which shall be in writing and reviewed periodically, regarding its relationships with the Distributors it appoints. Such policies and procedures should as a minimum cover the following:
- a) Criteria and procedures governing the choice of those Distributors;
  - b) Roles and responsibilities of the different parties;

- c) provision of information to assist Distributors in identifying conditions when Products should not be distributed to a group of Clients as referred to in R.2.13 or to the identified target market;
- d) flagging of key risks and returns.

R.2.35 A Manufacturer shall select distribution channels that are appropriate for the identified target market.

R.2.36 In selecting distribution channels, the Manufacturer shall ensure that the selected persons have the appropriate knowledge and expertise to correctly place each product on the market and to give the proper information or advice to the identified target market.

R.2.37 The Manufacturer shall ensure that information and details to be provided to any Distributor shall be of an adequate standard and be clear, precise and up to date. The information to be provided to the Distributor shall also include information on the Product approval process, including the identified target markets of the products in question.

R.2.38 The information given to Distributors shall be sufficient to enable them to give advice, where this service is offered, to the identified target market and to extract the relevant information that needs to be communicated to clients. A Manufacturer must at least provide the following information to a Distributor of its Products:

- a) The key characteristics and features of the Product;
- b) The target market for which the product is designed, and also the group of Clients for which the Product is considered unlikely to meet their interests, objectives and characteristics as well as the basis on which this on which such considerations were made.
- c) The nature and extent of the risks inherent in the Product; and
- d) The level, nature, extent and limitations of any guarantee attaching to the Product as well as the name of the guarantor.

R.2.39 The information which a Manufacturer supplies to the distributor shall not substitute the suitability assessment and the specification of the demands and needs of a specific client and the underlying reasons for any advice given by the Distributor.

R.2.40 The Manufacturer shall take all reasonable steps to ensure that Distributors distributing its products act in compliance with the Manufacturer's Product oversight and governance arrangements.

- R.2.41 The Manufacturer shall verify, on a regular basis, that the product is distributed to the Identified target market.
- G2.6 *The Manufacturer should consider carrying out surveys amongst a number of Clients to verify whether they understood the Product features as well as verify whether they fit into the identified target market and take appropriate action where necessary.*
- R.2.42 When the Manufacturer considers that the Distributor does not meet the objectives of its own Product oversight and governance arrangements, they should take remedial action.

### **Product Governance Obligations for Distributors**

- R.2.43 A Distributor shall:
- a) specify an identified target market of clients for each Product it offers to Clients and shall only offer Products with features , charges , risks that meet the interests, objectives and characteristics of and are of benefit to the identified target market and through appropriate distribution channels. For the purposes of specifying the identified target market, a Distributor shall consider the factors indicated in R. 2.14;
  - b) identify the groups of Clients for which the product is considered unlikely to meet their interests, objectives and characteristics;
  - c) establish, implement and review Product oversight and governance arrangements in place to ensure that the Products, which it intends to offer, are compatible with the characteristics, objectives and needs of an Identified target market. These arrangements should be proportionate to the nature, scale and complexity of the risks inherent to the business of the Manufacturer
  - d) when deciding on the range of Products to be offered and the respective target markets, maintain procedures and measures to ensure compliance with all applicable regulatory requirements including those relating to disclosure, inducements and proper management of conflicts of interest and, in the case of financial instruments, requirements relating to suitability and appropriateness;
  - e) carry out a periodic review of the Product governance and oversight arrangements already put in place to ensure that they remain robust and fit for purpose, taking appropriate action where necessary;

- f) review the Products offered or marketed on a regular basis, taking into account any event that could materially affect the potential risk to the Identified target market, in order to assess as a minimum whether the Product remains consistent with the needs of the identified target market and whether the intended distribution strategy remains appropriate. If the Identified target market for a specific Product has been mis-judged or a given Product no longer meets the circumstances of the Identified target market, the Distributor should reconsider the Identified target market and/or update the Product governance and oversight arrangements already put in place, as appropriate;
- g) provide sales information to Manufacturers to assist them in meeting their post-sale Product oversight and governance responsibilities such as Product reviews;
- h) involve its compliance function in the development and periodic review of Product oversight and governance arrangements in order to detect any risk of failure by Distributors to comply with their obligations in terms of this Chapter;
- i) ensure that the relevant staff involved in the development of Product oversight and governance arrangements fully understand the characteristics and risks of products and services that will be offered, as well as the characteristics, objectives and needs of the Identified target market;
- j) ensure that its Management Body shall be ultimately responsible for the establishment, subsequent reviews and continued compliance with its product oversight and governance arrangements and that the Management Body endorses the range of products that will be offered together with their respective identified target markets. Information about the Products offered should be included in the compliance function's periodic reports to the Management Body and made available to the MFSA on request;
- k) have adequate arrangements to obtain information referred to in R. 2.21 and to understand the characteristics and identified target market of each Product it distributes;
- l) ensure that relevant staff assigned the task to sell a Product in line with the Distributor's Product oversight and governance arrangements, in addition to complying with the requirements of R.XX<sup>1</sup> is also competent, possesses the necessary expertise and is appropriately trained and understands the

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<sup>1</sup> To eventually cross refer to relevant rules in the Chapter relating to Sales Process once the Rulebook is complete

Product's main features and characteristics as well as the interests, objectives and characteristics of the identified target market.

- m) shall take all reasonable steps to ensure that it acts in compliance with the product oversight and governance arrangements of the Manufacturers of each of the Products which it offers.
- n) shall verify, on a regular basis, that Products are offered to the respective Identified target markets.
- o) Cease to offer a Product to Clients if it considers that the Product no longer meets the interests and objectives of the identified target market which the Distributor has specified for it in accordance with paragraph (a) of this Rule.

R.2.44 Where different Distributors work together in the distribution of a product, the final distributor in the chain has ultimate responsibility to meet the above obligations contained in R.2.43 but an intermediate distributor must:

- a) ensure that relevant Product information is passed from the Manufacturer to the final Distributor in the chain;
- b) if the Manufacturer requires information on Product sales in order to comply with its own Product governance obligations, enable the Manufacturer to obtain such information; and
- c) apply the Product governance obligations for Manufacturers as relevant, in relation to the service they provide.

R.2.45 All relevant arrangements and action taken by the Distributor in relation to the Product oversight and governance arrangements should be duly documented, kept for audit purposes and made available to the MFSA upon request.

### **Obligations for Distributors distributing products by Third Country Manufacturers**

R.2.46 When Products are manufactured or issued by third-country manufacturer based in a non-EEA Member State, the Distributor shall take all reasonable steps to ensure that the level of Product information obtained from the third country manufacturer is of a reliable and adequate standard to ensure that products will be distributed in accordance with the characteristics, objectives and needs of the target market. Where all relevant and material information is not publicly or otherwise available, the reasonable steps required shall include an agreement with the manufacturer or its agent that the manufacturer or its agent will provide all relevant information. Publicly available information may only be accepted if it is clear, reliable and produced to meet the requirements of any relevant EU Directive.

**Obligations for a Regulated Person which acts both as a Manufacturer and Distributor**

R.2.47 When a person acts both as a Manufacturer and a Distributor, it is required to fulfil all relevant obligations set out for both manufacturers and distributors, provided that where a person is responsible for both product manufacture and distribution, it need only have a single Product governance process, as long as all relevant Product obligations are met.

**Rules applicable to Manufacturers and Distributors of Structured Products.**

*Product Testing Obligations in relation to Structured Products*

- R.2.48 A Manufacturer of Structured Products shall:
- a) consider the characteristics, especially the risk characteristics, of the Structured Product, such as illiquidity and riskiness of the underlying asset(s) and shall have an understanding of the model and input parameters as well as the assumptions built into the valuation of the Structured Product;
  - b) back test Structured Products, such that the Manufacturer may understand how it would have performed in the past;
  - c) undertake simulations of future performance scenarios to assess whether likely outcomes of the Structured Product would meet the investment objectives of the identified target market;
  - d) ensure that risk management methods used are consistent with the manufacturer's internal risk management framework. Testing should consider extreme economic environments (stress testing) and to include quantitative assessments of external (primarily financial) risks;
  - e) make available the results of tests and scenarios to distributors.
- R.2.49 A Distributor of Structured Products shall ensure that it is aware and understands the results of the tests as well as the simulations of performance scenarios undertaken by the manufacturer. The Distributor, should as a minimum, adopt adequate arrangements to examine critically those results and scenarios and if needed employ an independent third-party with the relevant expertise.

*Modelling and statistical test analysis to be used when designing Structured Products.*

R.2.50 Prior to the issue of a Structured Product, the manufacturer shall conduct robust, unbiased and arbitrage-free testing as to allow for an external party to adequately

challenge the Structured Product's pricing, valuation and risk/reward trade-off relative to the identified target market.

Distribution Strategy in relation to Structured Products

- R.2.51 A Manufacturer of Structured Products shall adopt appropriate policies and procedures regarding its relationships with the distributors it appoints. Such policies and procedures should also cover the provision to distributors of sufficiently detailed information about the Structured Products' pay-off structure, the model, valuation methods and the Structured Product risk / return scenarios.
- R.2.52 When receiving information provided by a Manufacturer of Structured Products, the Distributor shall:
- a) consider, when providing the information provided by the manufacturer to clients, whether they understand the information included;
  - b) ask the Manufacturer to supply additional information or training where that seems necessary to understand the Structured Product adequately.

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