

TO : i. Cyprus Investment Firms ('CIFs')
ii. UCITS Management Companies ('UCITS MC')¹
iii. Alternative Investment Fund Managers ('AIFMs')²

FROM : Cyprus Securities and Exchange Commission

DATE : 15 September 2017

CIRCULAR NO : C236

SUBJECT : Product Governance requirements under MiFID II

A. INTRODUCTION

1. The Cyprus Securities and Exchange Commission ('CySEC') wishes with this circular to inform the CIFs, UCITS MC and AIFMs on their obligations regarding product governance requirements, which are provided in the [Investment Services and Activities and Regulated Markets Law L. 87\(I\)/2017](#) (the 'Law')³ and in other documents issued pursuant to this. These requirements will enter into force on 3 January 2018.
2. In order to avoid and reduce from an early stage potential risks of failure with investor protection rules, investment firms⁴ manufacturing and distributing financial instruments should comply with product governance requirements. For the purpose of product governance requirements, investment firms that create, develop, issue and/or design financial instruments, including when advising corporate issuers on the launch of new financial instruments should be considered as manufacturers while investment firms that offer or sell financial instruments and services to clients should be considered distributors.

¹ Management companies when providing services pursuant to section 109(4) of Law 78(I)/2012, as in force.

² AIFMs when providing services pursuant to section 6(6) of Law 56(I)/2013, as in force.

³ The Law transposes the [Directive 2014/65/EU](#) on markets in financial instruments ('MiFID II').

⁴ References to investment firms or firms to this circular include UCITS MC and AIFMs and the text should be read as referring to them as well.

3. The objective of product governance requirements is to enhance the level of investor protection by regulating all stages of the life-cycle of products or services in order to ensure that firms which manufacture and distribute financial instruments and structured deposits act in the clients' best interests.

The product governance requirements address issues specific to manufacturers and distributors as well as issues common to both.

B. REGULATORY FRAMEWORK

4. The following legal documents are relevant to the product governance requirements:
 - i. The Law [articles 17(3) and 25(2)].
 - ii. [Commission Delegated Directive \(EU\) 2017/593](#) with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits⁵ (Chapter III).
 - iii. Guidelines on MiFID II product governance requirements – [ESMA35-43/620](#).

C. PRODUCT GOVERNANCE REQUIREMENTS FOR INVESTMENT FIRMS MANUFACTURING FINANCIAL INSTRUMENTS

5. Investment firms are required to comply, in a way that is appropriate and proportionate, with the product governance requirements, taking into account the nature of the financial instrument, the investment service and the target market for the product. The main regulatory requirements for investment firms manufacturing financial instruments are mentioned in points 6 – 20 below.
6. Investment firms shall maintain, operate and review a process for the approval of each financial instrument and significant adaptations of existing financial instruments before it is marketed or distributed to clients.

The product approval process specifies an identified target market of end clients within the relevant category of clients for each financial instrument. In this context, the investment firm ensures that relevant risks to such identified target market are assessed and that the intended distribution strategy is consistent with the identified target market.

7. Investment firms shall establish, implement and maintain procedures and measures to ensure that the manufacturing of financial instruments complies with the requirements on proper management of conflicts of interest, including remuneration.

⁵ It will be soon transposed into national law in the form of a directive.

8. Investment firms shall analyse potential conflicts of interests each time a financial instrument is manufactured.
9. Investment firms shall consider whether the financial instrument may represent a threat to the orderly functioning or to the stability of financial markets before deciding to proceed with the launch of the product.
10. Investment firms shall ensure that relevant staff involved in the manufacturing of financial instruments possesses the necessary expertise to understand the characteristics and risks of the financial instruments they intend to manufacture.
11. Investment firms shall ensure that the board of directors has effective control over the firm's product governance process.
12. Investment firms shall ensure that the compliance function monitors the development and periodic review of product governance arrangements in order to detect any risk of failure by the firm to comply with the product governance requirements.
13. Investment firms, when they collaborate, including with entities which are not authorised and supervised in accordance with MiFID II or third-country firms, to create, develop, issue and/or design a product, to outline their mutual responsibilities in a written agreement.
14. Investment firms shall identify 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 compatible. As part of this process, the firm shall identify any group(s) of clients for whose needs, characteristics and objectives the financial instrument is not compatible.
15. Investment firms shall undertake a scenario analysis of their financial instruments which shall assess the risks of poor outcomes for end clients posed by the product and in which circumstances these outcomes may occur.
16. Investment firms shall determine whether a financial instrument meets the identified needs, characteristics and objectives of the target market.
17. Investment firms shall consider the charging structure proposed for the financial instrument.
18. Investment firms shall ensure that the provision of information about a financial instrument to distributors includes information about the appropriate channels for distribution of the financial instrument, the product approval process and the target market assessment and is of an adequate standard to enable distributors to understand and recommend or sell the financial instrument properly.

19. Investment firms shall review the financial instruments they manufacture on a regular basis, taking into account any event that could materially affect the potential risk of the identified target market. Investment firms shall consider if the financial instrument remains consistent with the needs, characteristics and objectives of the target market and if it is being distributed to the target market, or is reaching clients for whose needs, characteristics and objectives the financial instrument is not compatible.
20. Investment firms shall 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 instrument functions as intended.

D. PRODUCT GOVERNANCE REQUIREMENTS FOR INVESTMENT FIRMS DISTRIBUTING FINANCIAL INSTRUMENTS

21. Investment firms are required, when deciding the range of financial instruments issued by themselves or other firms and services they intend to offer or recommend to clients, to comply, in a way that is appropriate and proportionate, with the product governance requirements, taking into account the nature of the financial instrument, the investment service and the target market for the product. The main regulatory requirements for investment firms distributing financial instruments are mentioned in points 22 – 32 below.
22. Before distributing a product, investment firms shall determine the target market for the respective financial instrument, even if the target market was not defined by the manufacturer.
23. Investment firms shall have in place adequate product governance arrangement to ensure that the products and services they intend to offer or recommend are compatible with the needs, characteristics, and objectives of an identified target market and that the intended distribution strategy is consistent with the identified target market. Firms shall identify any groups of clients for whose needs, characteristics and objectives the product or service is not compatible.
24. Investment firms shall obtain from manufacturers information to gain the necessary understanding and knowledge of the products they intend to recommend or sell in order to ensure that these products will be distributed in accordance with the needs, characteristics and objectives of the identified target market.

In case the manufacturer is not subject to MiFID II, investment firms are also required to obtain adequate and reliable information in order to ensure that products will be distributed in accordance with the characteristics, objectives and needs of the target market.

25. Investment firms shall use the information obtained from manufacturers and information on their own clients to identify the target market and distribution strategy.
26. Investment firms shall maintain procedures and measures to ensure compliance with all applicable requirements under the Law, including those relating to disclosure, assessment of suitability or appropriateness, inducements and proper management of conflicts of interest.
27. Investment firms shall periodically review and update their product governance arrangements in order to ensure that they remain robust and fit for their purpose, and take appropriate actions where necessary.
28. Investment firms shall review the investment products they offer or recommend and the services they provide on a regular basis, taking into account any event that could materially affect the potential risk of the identified target market. Firms shall assess at least whether the product or service remains consistent with the needs, characteristics and objectives of the identified target market and whether the intended distribution strategy remains appropriate.
29. Investment firms shall ensure that their compliance function oversee the development and periodic review of product governance arrangements in order to detect any risk of failure or comply with the product governance requirements.
30. Investment firms shall ensure that the relevant staff possesses the necessary expertise to understand the characteristics and risks of the products that intend to offer or recommend and the services provided as well as the needs, characteristics and objectives of the identified target market.
31. Investment firms shall ensure that the board of directors has effective control over the firm's product governance process to determine the range of investment products that they offer or recommend and the services provided to the respective target markets.
32. Investment firms shall ensure that they provide manufacturers with information on sales and, where appropriate, information on the above reviews to support product reviews carried out by manufacturers.

E. PRODUCTS WHICH FALL UNDER PRODUCT GOVERNANCE REQUIREMENTS – APPLICATION TO PRODUCTS PRE-LAW

33. Product governance requirements apply to all products (financial instruments and structured deposits) sold on primary and secondary markets, irrespective of the type of product or service provided and of the requirements applicable at 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.

34. Products manufactured and distributed before 3 January 2018 do not fall within the scope of product governance requirements.
35. Products manufactured before 3 January 2018 but distributed after 3 January 2018 fall within the scope of product governance requirements applicable to distributors, who they will treat the manufacturers as if they were non-MiFID entity. However, the relevant regulatory requirements will be complied with in either scenario from the date the next product review process cycle after 3 January 2018.

F. ACTIONS REQUIRED BY INVESTMENT FIRMS

36. Investment firms should look at the product governance requirements and undertake an analysis of their existing procedures and arrangements regarding their products offered and services provided. Firms should take appropriate measures so as to ensure that as of 3 January 2018 they will comply fully with these requirements.

Among others, investment firms should consider the following:

- i. Target market identification (e.g. a target market for each product should be identified, the types of clients, their needs, characteristics, objectives, financial situation, risk tolerance, knowledge and experience should be specified, how factors that might affect target market are monitored and how are reflected in the target market).
- ii. Stress testing of existing products (e.g. whether these are robust, all risks posed by products are identified and fit with the identified target market and risks are adequately disclosed to investors).
- iii. Organisational requirements – corporate governance issues (e.g. whether the staff involved have the necessary expertise, what are the duties/responsibilities of the board of directors and what is the role of the compliance function in this process).
- iv. Charging structure (e.g. whether the charging structure is fair and clear to investors).
- v. Manufacturer/distributor liaison (e.g. who are the distributors, whether distribution chain is known, what information should be collected and how is collected and provided to distributors, whether distributors understand the product or further education is needed).

- vi. Agreements (whether the agreements between manufacturers, distributors, collaborated entities should be revisited).
- 37. Regarding points 10 and 30 above that require staff to possess the necessary expertise, CySEC encourages investment firms to certify their staff in accordance with the Directive of the CySEC regarding the Certification of Persons and the Certified Registers ([R.A.D.174/2015](#)) (at least to pass the basic exams and register in the Public Register).
- 38. By December 31, 2017 the latest, investment firms should provide CySEC with a declaration from their board of directors that they have taken all appropriate measures to comply with the law and all the relevant documents issued pursuant to this as of 3 January 2018. The declaration should be submitted through CySEC's web portal as a free text and have the following title: "C236 – Product Governance under MiFID II – Obligations for Regulated Entities".

Yours sincerely

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