For professional advisers only

May 2019

Product Intervention and Product Governance Sourcebook (PROD)

A Brief Introduction to PROD

In establishing PROD the FCA has been consistent in its objective of seeking to deliver better outcomes for investors. In the Asset Management Market Study, we saw a focus on cost and value; in the Investment Platforms Market Study Interim Report, we saw a focus on facilitating greater competition; whilst in PROD attention is given to ensuring that products are relevant to a client's need and that the product continues to be appropriate.

The purpose of PROD is clearly defined *'.....to improve firms' product oversight and governance processes and to set out the FCA's statement of policy on making 'temporary product intervention rules.'* Clarifying that 'product oversight and governance' refers to systems and controls firms have in place to design, approve, market and manage products throughout the products' lifecycle to ensure they meet legal and regulatory requirements' could easily lead to the conclusion that PROD is directed toward product manufacturers, which indeed it is, but not in isolation.

PROD 1.3.1 and 2 states clearly that PROD 3 applies to firms 'distributing financial instruments, structured products and investment services'. We would encourage you to familiarise yourself with PROD in its entirety, although below we have provided a brief summary of Chapter 3.3, which specifically relates to Distributors of Financial Instruments.

The dominant phrase in The PROD Sourcebook is 'Target Market' and the regulator wants both the manufacturers to define this for their products and for the distributors, or advisers, to match the resultant descriptors with their clients.

Through PROD the future relationship between advisers and manufacturers is set to change, with the purpose of ensuring that the regulator's objectives are met. It is very likely that regulatory visits in the future will focus on matching the target market information of manufacturers with that of advisers. Alarm bells will inevitably ring where this is not the case...

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Key points to note for Distributors (Advisers)

- Advisers are required to obtain the necessary information from the manufacturers of financial instruments to have the required knowledge to determine the appropriateness of an instrument for each client.
- Advisers, based on the information received from Manufacturers and their own understanding of their clients, must determine a Target Market for each product.
- Distribution strategies should be consistent with the identified target market.
- The financial strength of manufacturers and their ability to deal with complaints is a factor that needs to be considered.
- The advisers' management function needs have control over the distribution process, with oversight from Compliance.
- Employees involved in the distribution of financial instruments must have the necessary understanding and knowledge to understand the instruments they are promoting.
- On-going reviews must be conducted to determine whether instruments and distribution strategies remain relevant to clients.
- The sharing of information with manufacturers will be required.
- Procedures to manage any Conflicts of Interests are required.

Summary of PROD 3.3

Chapter 3: Product governance: MIFID

Chapter 3 of PROD consists of three sections. The first (3.1) a general introduction; the second (3.2) is focused on product manufacturers; and the third (3.3) on the distribution of products and investment services. Below we have provided a brief summary of 3.3.

3.3.1 – 3.3.2 General

- As a distributor (adviser) you must understand the instruments that you advise your clients to invest in. This is no different to the requirements for due diligence as set out in TR16/1 but the key here is to demonstrate and document that due diligence and understanding.
- You must assess the compatibility of the financial instrument with the needs of each of your clients. This is no different to the requirements of the 2011 FSA paper on suitability. However the emphasis is on the 'outcome' matching the client need and it will not be acceptable to simply match a product to a client's Attitude To Risk and Capacity For Loss. Once again, documentation is key. This is likely to include an articulation of the discussions that have been held with clients in the suitability letter.
- You must match the manufacturers' target market statements to the needs of each of your clients. This may well be simpler than the regulator originally intended as many Asset Managers have chosen to describe their target markets as 'Retail Investors.'
- There is also a stipulated requirement to understand (and therefore document to evidence that understanding) the financial strength of the manufacturer and how effectively they will deal with queries or complaints.
- Be prepared to meet requests from the regulator for this documentation.

3.3.3 – 3.3.4 Obtaining information from manufacturers

- Advisers must obtain (and therefore document) information from the manufacturers to ensure that distribution is in line with the needs, characteristics and objectives of their clients.
- Advisers should not advise on any product that they do not understand sufficiently.
- Be prepared to answer questions from the regulator that will demonstrate this knowledge.
- This applies not just at an investment committee level but for all staff who are advising clients.

3.3.5 – 3.3.8 Non MIFID financial instruments

- Sections apply to the additional requirements on advisers where the financial instruments are not subject to MIFID product governance requirements.

3.3.9 – 3.3.19 Target market and distribution strategy

- Advisers must establish what the appropriate target market is for a product. The guidance goes on to say that this should be matched to the manufacturer's target market output but stipulates (with a neat get out clause!) that it should be established 'even if this was not defined by the manufacturer.'

- This is important at an individual client level but has extra significance when part of a centralised investment proposition.
- In identifying a target market and having a clearly defined 'distribution strategy' an adviser must ensure that the fit of the end product considers the client's needs; along with the impact of charges on clients; the financial strength of the product manufacturer; and any possible interaction with a manufacturer.
- In identifying a target market for products and services advisers must also identify any sub-sets of clients for whom the product or service is not suited.
- Advisers must regularly review their product governance procedures to ensure that products and services remain compatible to their client's needs and that they take appropriate action when required.
- Advisers need to be mindful of conflicts of interest that can potentially exist within a business when recommending products and services to clients.
- Advisers need to determine how clients can be best informed to enable them to make informed decisions.
- Advisers should have examples of the negative selection and be able to demonstrate them working in practice.
- Advisers should be prepared to demonstrate a documented version of your policy – AND that it has been annually reviewed and signed off by appropriate officers.

3.3.20 – 3.3.23 Oversight and training requirements

- The adviser's compliance officer must periodically review the approach followed by the firm.
- The paper talks about 'the management body' of an adviser having effective control over the governance process. It is likely that this will be the responsibility of an 'Investment Committee.' This requires a 'Terms of Reference' outlining its responsibilities and methodology.
- Relevant staff need to be fully aware of the risks of the financial instruments that they may recommend; the risk that they represent to clients; and the target market for the product or service.
- Ensure that your existing terms of reference are updated to demonstrate adherence to PROD's requirements.
- If you are a network member or have outsourced compliance, all of this will invariably become an area of focus for compliance visits.

3.3.24 – 3.3.25 Compliance reports

- Reports to the investment committee must be made on all instruments and services provided to clients.
- Reports should cover due diligence and on-going suitability.
- Ensure that any outsourced investment arrangements are suitably covered, ideally through regular reporting to your investment committee.
- The document stipulates that all reports, if requested should be made available to competent authorities.
- This is how this will be policed – document, document, document AND be ready to supply that documentation, on demand, to the regulator.

3.3.26 – 3.3.29 Post sale review

- On-going suitability testing at an individual client level is not a new requirement BUT
- PROD requires that there be a periodic review to ensure ongoing suitability of an instrument or service – and the re-testing of the product versus the target market on a periodic basis.
- ...and the re-testing of the distribution strategy.
- Action may be required where an instrument is no longer what it declared itself to be. For example: illiquid or highly volatile.
- Be prepared to demonstrate the documents that evidence this process. These may be the Terms of Reference and minutes of your investment committee.

3.3.30 – 3.3.31 Information sharing

- This is a new requirement under PROD.
- To support manufacturers PROD obligations in defining target markets, advisers are obliged to supply, on request, information

on sales and information on their target market assessments.

- It is NOT necessary to supply information on every transaction BUT advisers must supply data to demonstrate segmentation and suitability.
- Information on product reviews should be supplied if manufacturers request them.
- Be prepared to demonstrate your due diligence, segmentation and suitability processes for each investment instrument or service that you advise upon.

3.3.32 – 3.3.33 Chain distribution

- A consideration for firms that may distribute instruments to clients who are not the end clients.

Impact of PROD

For Advisers already adhering to the requirements of suitability we suspect that PROD, along with a requirement to clearly understand the objective and the target markets of financial instruments, will be an extension of the practices already being undertaken.

Undoubtedly there is greater requirement to formally demonstrate actions being taken and possibly the introduction of more formal processes to do so. We have previously talked about the role of an Investment Committee within an Advisers practice and this seems an ideal vehicle to monitor and discharge such responsibilities.

For more information on PROD please email us at info@squaremileresearch.com or call 0203 830 8050

Important Information

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