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**"MANUFACTURER AND DISTRIBUTOR OF FINANCIAL PRODUCTS
AND THEIR ROLE TO PROTECT THE END CLIENT"**

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TABLE OF CONTENTS

Introduction	1
Chapter One: MiFID I and MiFID II	3
1.1 <i>Structure of MiFID I</i>	3
1.2 <i>Innovations of MiFID I and Purpose</i>	4
1.3 <i>Evolution of the Discipline: from MiFID I to MiFID II</i>	7
1.4 <i>MiFID II Revolution</i>	9
1.5 <i>Weaknesses and Flaws of MiFID I</i>	11
1.6 <i>MiFID II Changes</i>	12
Chapter Two: Information to Retail Client and Investor Protection	27
2.1 <i>Product Governance Overview</i>	27
2.2 <i>PRIIPs Regulation</i>	29
2.3 <i>MiFID Evolution about Investor Protection</i>	37
Chapter Three: Product Governance	49
3.1 <i>Introduction to Product Governance</i>	49
3.2 <i>A Deep Analysis of Product Governance Rules and an Insight into Manufacturer and Distributor Legal Framework</i>	52
3.3 <i>Complex and Structured Products</i>	76
3.4 <i>The Interconnection between Product Governance and Product Intervention</i>	79
3.5 <i>How Product Governance Affects Investor Protection: The Mis-selling Problem</i>	82
3.6 <i>Non-MiFID Firms and the Problem of Information-Gathering Process</i>	84
Conclusion	89
References	92
Legislation	102

Introduction

Mifid II is a legislative packaged, made up of the Directive 2014/65/EU and the Regulation 600/2014, which has been recently introduced by the European Union. In Italy, the Legislative Decree of August 3rd, 2017, was published on the Official Journal on August 25th, 2017, that includes the implementing rules of the Directive 2014/65/UE. The transposition of this directive affects significantly the Legislative Decree n. 58/1998 named TUF¹. MiFID II has been implemented with the aim at reaching a deeper integration of financial market in the EU area and ameliorate the investor protection as well as recover clients' confidence after the global financial crisis. It has replaced the existing Markets in Financial Instruments Directive (MiFID I) from 3rd of January 2018 and it represents a prominent upgrade of the old directive.

MiFID I (Directive 2004/39/EC)² becomes effective in November 2007 and the main objectives of it were to increase the transparency across the European Union's financial market, harmonise regulation for investment services and in general the legal frameworks for wholesale and retail market, increase competition and consumer protection in investment services and improve the competitiveness of EU financial markets by creating a unique European financial market for activities, investments and services.

Even if the former Directive had improved the financial framework and was useful mainly to remove the barriers in Europe, the financial crisis that occurred in 2008 underlined the weaknesses of this directive, in particular in the field of retail investor protection and market transparency because the rules haven't been applied in a consistent way, leaving MiFID I old-fashioned and inefficient.

As a consequence of this, the Regulator claimed to do a review of MiFID I in 2010 in order to ensure a more robust legislative framework that was necessary to address the more complex market system we are now faced with, the instable historic period which is depicted by the increasing diversity and complexity of financial products, new methods of trading and a fast development of technology.

Like all the set of laws that has been implemented after a period harmed by financial crisis, similarly the new MiFID package aimed to stabilize financial markets, and in general it is designed in order to provide greater protection for investors and improve asset classes'

¹ De Poli M. "*MiFID II e decreto legislativo di recepimento n. 129/2017. L'apparato sanzionatorio e la reazione a condotte antigiuridiche*", 2017.

² Directive 2004/39/EC of the European Parliament and of the Council on Markets in Financial Instruments, Official Journal of the European Union, 30 April 2004.

transparency. After a long period needed for the enforcement of the modified directive, MiFID II came into force on 3rd January 2018. This renewed rulebook provided changes for all market participants, investment firms, banks and clients, basing the innovations in particular on two pillars: market transparency and investor protection. The main purpose in fact was to improve financial stability and consumer confidence.

The retail client protection is a fulcrum in the updated Market in Financial Instrument Directive; it has firstly attempted to recover the investor confidence lost during the crisis that appear to be the starting point of the new rulebook.

In general, the integration improvement of European financial markets is pursued following several streams like increasing competition, improving efficiency and investor protection, expanding the supervision's competencies of authorities.

One of the most relevant innovation, for the purpose of reaching all the previous goals, in particular the transparency improvement and the increase of investor protection, is represented by the product governance regime. Through this new set of rules, the Regulator has decided to intervene at the root of the production process of financial instruments, namely the design and creation phase.

The correct functioning of these provisions should guarantee a market stability and integrity. Hence, after an overview of MiFID I and the legislative path towards the new regime implemented through the MiFID II package, will be explained the legal steps and tools introduced by the Regulator for the purpose of reaching the highest level of investor protection. In this context, will be analysed in detail all the features and rules embedded in the product governance regime.

Chapter One

MiFID I and MiFID II

The Markets in Financial Instruments Directive (MiFID I), is one of the most relevant set of law in the European Union concerning financial markets, companies and banks. The market in financial instrument directive (Directive 2004/39/CE)³, was first implemented in 2007 and was intended to replace the Investment Services Directive (ISD)⁴, which came into force in 1993. MiFID I attempted to create a competitive environment for the provision of investment services and an harmonised basket of rules across Europe in relation with a general liberalisation of investment services and a higher degree of investor protection. In a more detailed manner, the Regulator tried to renew the discipline regarding markets, investors and investment firms.⁵

1.1 Structure of MiFID I

The peculiarity of this legislative regime concerns the fact that it was not defined as one single directive, but it was a resulted document implemented at various levels step by step following the named “Lamfalussy procedure”⁶.

- I. First level is represented by the Directive 2004/39/CE and defines general principles of the ruleset;
- II. Second level is represented by the Regulation 1287/2006/CE⁷, that regards the discipline of markets, the pre- and post-trade transparency rules, and by the Directive 2006/73/CE⁸ that disciplines the role of the intermediary that offer investment services;

³ Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC.

⁴ Council Directive 93/22/EEC of May 1993 on investment services in the securities field.

⁵ Capriglione F. “*Preliminary considerations on the MiFID II Directive (between investors’ expectations and actual legal framework)*”, in *Rivista Trimestrale di Diritto dell’Economia*, February 2015.

⁶ “*The Lamfalussy architecture*”, European Commission.

⁷ Commission Regulation (EC) n°1287/2006 of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards recordkeeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive.

⁸ Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive.

- III. Third level corresponds to the guidelines of Committee of European Securities Regulators (CESR) and was implemented in order to manage, receipt and apply at national level all the regulatory acts defined in the previous levels.
- IV. The Fourth level process is the on-going review and enforcement by the European Commission.

1.2 Innovations of MiFID I and Purpose

In general, the Directive 2004/39/CE has been designed in order to reach harmonization in the legal framework for retail and wholesale market, improve the competitiveness of European financial market by creating a single market, augment stability and reach a higher degree of investor protection. More in details, the Regulator sought to insert, modify and ameliorate a lot of disparate fields considering this revision as the starting point necessary to achieve the aforementioned goals.

A brief bullet list is explained below:

- Authorisation, regulation and passporting:

The passporting arrangement was introduced in order to allow MiFID firms to provide services in all European Member States⁹. It is an important pillar in the functioning of global financial market and states that firms are regulated firstly by their home country but then can operate in other EU host states;

- Client order handling:

This phase regards the collection of information that are fundamental for the firm in order to act in the client's best interest, in a favourable and profitable way¹⁰;

- Client categorisation:

It is based on three classes of clients: eligible counterparties, professional clients and retail clients. The firms have to collect all the available information to classify clients and then they have to decide what products or services could have a possible match with these different types of clients. The client categorisation is a relevant part in the legislative regime because is linked

⁹ Kemp R., "*MiFID (the markets in financial instrument directive) and technology*", in Computer Law & Security Report 24, Volume 4, Issue 2, pp. 151-162, 2008.

¹⁰ Sepe M., "*La nuova regolazione dei mercati finanziari*", 2016.

with the protection level of the investor, in fact the degree of protection is established basing on the aforementioned classification.

In this way, a better knowledge and experience the investor will have, the lower the level of protection will be.

- Pre- and post-trade transparency rules:

The set of rules managing transparency issues plays a central role in the Directive. The European Regulator, through the extending process of these rules, has intended to enhance liquidity and improve the investor protection. Besides they are useful to support venues' trading mechanism, disclosure market data seeking to monitor and avoid systemic risks¹¹.

- Inducements and conflict of interest rules:

The organisation requirements sector of MiFID provides rules aimed at avoiding any possible conflict of interest between firms and clients' interests; furthermore, the investment firms should reveal commission, fees and non-monetary benefits that are not directly linked with the investment service or that aren't useful to improve the quality of the services provided.

- Best execution:

This provision obliges firm to consider all steps and information needed to obtain the best possible result in accordance with the client's best interest ensuring a higher degree of investor protection. This is applied for execution of orders on behalf of clients, reception and transmission of order and portfolio management service.

- Systematic internalization¹²:

It is linked with the elimination of the concentration rule¹³ (art 14 (3) of the 1993 Investment Service Directive ISD)¹⁴; with the cancellation of concentration rule, trades may be executed in alternative trading systems different from the main and regulated market¹⁵.

¹¹ "MiFID 2.0: Casting New Light on Europe's Capital Markets", Pierre Francotte, Diego Valiante and Karel Lanno.

¹² Anolli M., Petrella G., "Internalization in European equity market following the adoption of the EU MiFID Directive", in Journal of Trading, Vol. 2, No. 2, pp. 77-88, 12 April 2007.

¹³ The rule in art. 14 (3) of the 1993 ISD disciplined that each member countries had the right to concentrate all orders on a regulated market.

¹⁴ Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities filed.

¹⁵ Davis R., Dufour A., Scott-Quin B., "The MiFID: competition in a new European equity market regulatory structure", 14 July 2005.

Purpose

Despite all the innovations provided by the Market in Financial Instrument Directive, we can declare that there are three main themes managed by MiFID I that are investor protection, market access and transparency.

In particular as regards the investor protection, the Directive established a new set of procedures for the firms with the purpose of conducting their business in a sound manner as well as removing the conflicts of interests¹⁶. This assures that investors receive an adequate set of information about firm's execution practices and that operates in the best interest of clients as well as the introduction of trading rules (order handling, trade reporting rules, order execution)¹⁷.

Talking about market access instead, MiFID I through the application of the "passport" allowed firms to provide services in the other Member States and to have access to regulated market in the host country¹⁸.

Transparency means a series of provisions that regulates pre- and post-trade transparency obligations¹⁹.

The aim of the harmonization and homogenization of the market had been predetermined for the purpose of improving confidence in cross border trade and competition, increasing the investor protection and reducing the inefficiency.

In 2008 the global Financial crisis occurred and stressed weaknesses and flaws of the old rulebook; the effort of the directive to protect investors resulted not applied in a consistent and efficient way. The financial troubles left the Directive suddenly inefficient and old fashioned due to the quick transformation of the markets and the overall financial system.

As a consequence of this, the Regulator, with the aim to solve the flaws of the directive, has decided to make some adjustments of MiFID I in 2010. The resulting review was composed by two new pieces of legislation: MiFID II, a new Directive and MiFIR²⁰, a Regulation. These texts became law in 2014 and were introduced in January 2018. The package of reviewed rules was designed to enhance the efficiency, resiliency and integrity of financial market; it also aimed at redefining market infrastructure and improving market transparency. Forming a

¹⁶ Art. 13, 18, 19 of Directive 2004/39/EC of the European Parliament and of the Council on Markets in Financial Instruments, Official Journal of the European Union, 30 April 2004.

¹⁷ Art. 21, 22, 25 of Directive 2004/39/EC of the European Parliament and of the Council on Markets in Financial Instruments, Official Journal of the European Union, 30 April 2004.

¹⁸ Art. 31 of Directive 2004/39/EC of the European Parliament and of the Council on Markets in Financial Instruments, Official Journal of the European Union, 30 April 2004.

¹⁹ Art. 27, 28, 29, 30, 44 of Directive 2004/39/EC of the European Parliament and of the Council on Markets in Financial Instruments, Official Journal of the European Union, 30 April 2004.

²⁰ Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012.

comprehensive revamping of the existing directive, MiFID II and MiFIR enlarge the field of application and at the same time seek to cover the “dark holes” left by the old Directive. On the top of the hierarchical pyramid’s innovations remains again the effort to strengthen the protection of investors, probably the cornerstone of the new legislative package.

1.3 Evolution of the Discipline: from MiFID I to MiFID II

As I have reported before, the Directive 2004/39/UE (MiFID I), has provided the regulatory framework regarding principally the investor protection and the supply of financial products and investment activities by investment firms.

The main objectives that were pursued by the introduction of MiFID I could be summarized in:

- the attempt to improve efficiency, competitiveness and integration of European financial markets through the creation of a unique market for investment activities and services;
- a higher level of investor protection, an extended regulation of transparency and safety of the market through an increased set of rules addressed intermediaries²¹;
- an increase in competition within the European Union in term of activities and investment services.

MiFID II aimed at innovating and integrating the previous Directive, without modifies the cornerstone, and increasing the restrictions and behavioural rules of intermediaries.

One of the most important change in the new Directive turns around the position of the client. Now the client covers a central role in the new legislative package; a solid investor protection becomes fundamental in the economic environment in order to ensure stability in the financial market. In this way, the new rules require that the investor protection process starts in the very early stage in the financial instrument production. This can be achieved only increasing the rigidity of the financial institutions’ internal rules.

The introduction of MiFID II was characterized with a step by step implementation procedure that passes through a huge number of consultations, revisions and corrections of the original text.

²¹ Davies J. R., “*MiFID and a changing competitive landscape*”, July 2008.

Brief roadmap towards the introduction of MiFID II²²:

- In December 8th, 2010 the European Commission launched a consultation to review MiFID I.
- In October 20th, 2011 the European Commission made official the new MiFID II (Market in Financial Instruments Directive 2014/65/EU of the European Parliament and of the Council) defining it as a part of revision of the previous Directive as well as a part of the new Regulation entitled MiFIR (Regulation N. 600/2014 of the European Parliament and of the Council).
- Between April and July 2014, the European institutions adopted in a formal level the new Directive MiFID II; more precisely on April 15th, the Council adopted the final texts for the two documents while in July they were published in the Official Journal entering into force.
- In September 28th, 2015, ESMA²³ proposed the transformation of laws in functioning technical standards (Regulatory Technical Standard, Implementing Technical Standard, Technical Advice). ESMA moreover has published Guidelines that are subject to a periodically upgrade.
- In October, 2015, ESMA declared to the European Commission that it wasn't able to introduce the Directive in January 2017²⁴.
- In February, 2016, the European Union decided to officially postpone the introduction of MiFID II for a year.

²² Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.

²³ On November, 1st, 2011, became effective and operative some supervisory European authorities, i.e. EBA for the banking sector, ESMA for markets and financial product and EIOPA for the pension and insurance system; in a strict relationship with them there is ESRB that manages the micro-prudential supervision. Furthermore, all supervision authorities, national and supranational are linked through a network called European System of Financial Supervision (ESFS) useful to maintain stability of financial system, create confidence and assure a high level of investor protection. Pellegrini M. *“MiFID II e complesso autoritativo di vigilanza europea. In particolare l'ESMA”*.

²⁴ Sesti G. *“Going further on investors' protection: product governance, product intervention and the role of ESMA”*, In Rivista Trimestrale di Diritto dell'Economia, January 2016.

- In January, 3rd, 2018, MiFID II and MiFIR were applied for all member states of the European Union.

The MiFID II Directive and the MiFIR Regulation together with the related delegated acts and guidelines compose a legislative package that is commonly referred to as “MiFID II”.

1.4 MiFID II Revolution

The recent Global Financial Crisis related to subprime mortgages and Alt-A loans²⁵ undermined market stability and affected negatively the investors’ confidence²⁶ as well as the takedown of the whole financial system²⁷. Several other factors like technological changes, development of markets, implementation of new trading platforms and activities which fall outside the aim of MiFID I, have played a central role in the need of restructuring of the previous directive. All these players, together with the instable financial situation, led to a necessary overhaul of the legal framework governing financial markets. Closing such holes was essential in order to attempt to reach all the MiFID’s original goals.

For this reason, mainly, European authorities have decided to review and extend the aim of Market in Financial Instruments Directive (MiFID I) few years later after the creation. This new rulebook, composed by a Directive, the MiFID II and by a Regulation, the MiFIR, has been introduced in order to correct the weaknesses and the limits highlighted by the crisis, to reduce the typical information asymmetries of the market and to reach a deeper integration of European financial markets.

The Regulator aimed at reaching a sounder, safer, fairer, more stable and more efficient financial market strictly linked with an improvement in the investors’ confidence and protection. In general, the main goal pursued by the authorities was to create a unique European financial market, in particular ensuring a more transparent market and a higher degree of investor protection.

The acknowledged of MiFID II in the national law systems and the entry into force outline an evolution of the previous discipline around the European market. MiFID II covers a relevant position in the legal framework because, on one hand it has corrected the holes in the old directive but maintaining the previous fundamentals, on the other hand has introduced important innovations that probably will characterize all the future financial system.

²⁵ Alt-A are loans that are considered riskier than prime loans but less risky than subprime loan.

²⁶ Wallison J. P., Burns F. A., “*Financial crisis inquiry commission*”, January 2011.

²⁷ Akinbami F., “*Retail financial products and the global financial crisis*”, 20 June 2012.

In January 3rd, 2018, the New Directive MiFID II came into force regulating financial markets in 31 countries in the European Economic Area, (more precisely 28 countries of the European Union plus Island, Liechtenstein and Norway) and it was addressed to all financial firms like banks providing investment services, asset management companies, brokerage companies, security firms, regulated market operators and energy and commodity players.

An important issue to take into consideration is that the Directive is supported by a detailed Regulation called MiFIR, a set of technical standards issued by ESMA and European regulations²⁸ (in details with the implementation of forty-five Delegated Acts²⁹).

In this way we talk about MiFID II like a complex “package” because it is articulated in several levels; this approach is essential for a correct interpretation and application in order to analyse the Directive together with other legal texts.

Among these, the most important are the EMIR³⁰, the PRIIPs regulation and the Insurance Distribution Directive (IDD)³¹; obviously there are other interconnections with other disciplines but less relevant. For this reason, the legal package comprehends a vertical side, due to different degrees of articulation, and a horizontal side because of the interactions with different legal frameworks that are at the same time intensely linked.

The MiFID II Directive is articulated in levels and its structure is very similar in comparison with the structure of the old directive. The legislative process for the new directive involves four stages:

- I. First Level: MiFID II and MiFIR compose the first level which is the framework of legislation. The MiFID II side includes requirements for investment services, investment firms, trading venues, third-country firms, competent authorities’ powers and obligations for providers of data services. On the side of MiFIR there are provisions about trade transparency, mandatory trading rules of derivatives and specific provision on supervisory actions in financial instruments.

²⁸Annunziata F. “*Il recepimento di MiFID II: uno sguardo di insieme, tra continuità e discontinuità.*”, in Rivista delle Società, April 2018.

²⁹ Legal reference to Delegated acts which are listed in ESMA website <https://www.esma.europa.eu>.

³⁰ EMIR is the acronym of European Market Infrastructure Regulation. In March, 29th, 2012 it entered into force after the European Parliament had adopted the final version of EMIR; it seeks to improve transparency in derivatives markets and wants to reduce systemic risk. As a result of this agreement all standardised OTC derivatives contract must be cleared through central counterparties. It in complex represents a monumental change in the regulation of the over-the-counter derivatives market.

Morton J. “*MiFID II. Getting ready for January 2018.*”, Bloomberg.

³¹ Directive (EU) 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution.

II. Second Level: this level was developed between 2014 and 2016; it was composed by Commission Delegated acts, Commission Implementing Regulations, Commission Delegated Regulations and ESMA's Guidelines. In particular, the Consultation Paper of ESMA defines propositions for its technical advice to the Commission on the proposed delegated acts for the purpose of modify the MiFID Implementing Directive. Therefore, the Consultation Paper regards several investor protection provisions in MiFID II.

After that, ESMA has published in 2014 some Technical Advice and then are published the MiFID II Delegated Regulation, the MiFID II Delegated Directive and the MiFIR Delegated Regulation.

This last one Delegated Regulation has direct effect while Delegated Directives have to transpose into national jurisdiction by each country. As regards to Technical Standards instead, the ESMA Discussion Paper shifts the attention on innovations like market structure, transparency and data reporting; then ESMA has published final draft of Technical Standards in the second half of 2015. Technical Standards are divided into two classes: regulatory technical standards (RTS) and implementing technical standards (ITS); the Commissions has decided to adopt them in 2016.

III. Third Level: it consists of recommendations, consultations and Guidelines published by ESMA including important topics like:

- Debt instruments and structured products
- Valuation of the investment advisor's skills and competences
- Transaction reporting
- Product governance
- Investor protection

IV. Fourth Level: this level is characterized by the supervision and the execution of requirements that Member States must comply.

1.5 Weaknesses and Flaws of MiFID I

Coming back to the past, MiFID I certainly had improved the financial systems' situation providing important innovations, but the crisis burst in 2008 undermined the Directive making it immediately outdated and inefficient afterward.

The progressively deterioration of the financial system uncovered a lot of weaknesses linked to important fields of MiFID which represented the cornerstone of the legislative framework. The most relevant issues are:

- The risk profile of the client, one of the most important pillar of the Directive, was replaced with a questionnaire that was often filled in a shallow manner without comply with the central aim of this process.
- The problem of conflict of interests has harmed a huge number of financial activities; MiFID II aims at providing not only with a better management of this problem but seeking to avoid them completely.
- The asymmetric information problem, that represents an already intrinsic peculiarity of each investment activities, was exacerbated by dishonest behaviours of intermediaries who supplied financial instruments barely understandable.
- In some case intermediaries, pushed from internal budgeting goals, have provided internal financial instruments to client of whom risk profile was not appropriate for the products' peculiarities. In order to deal with this problem, MiFID II requires to intermediaries a high degree of competences and skills³².

1.6 MiFID II Changes

MiFID II maintains the original general bipartition of the previous directive such that, on one hand it concerns all the discipline about trading venues, on the other hand about investment services but analysing it in a deeper manner and providing more granular rules.

MiFID II has introduced innovations and modification, aimed at establishing a sounder, more transparent and safer financial system, that could be summarized in six main streams of application:

- Market structure framework
 - enhanced governance of trading venues
 - introduction of OTF
- Transparency and transaction reporting

³²Bertelli R. *“Perché MiFID non ha funzionato”*, Antonio Criscione, in *Il sole 24 ore-PLUS24, bancadati24*, Dicembre 2017.

- Improved pre- and post-trade transparency
- Greater consolidation of market data (APA, CTP, ARM)
- More extensive transaction reporting
- Enhanced regulation of Algo-Trading and High Frequency Trading
- Equity market transparency

- Supervision
 - Harmonised powers and conditions for ESMA
 - Product intervention
 - Harmonisation of administrative sanctions

- Commodity Derivatives
 - More intensive regulation of commodity derivatives

- Non-EU Investment Firms
 - New framework for third-country firms to access EU market

- Investor protection
 - Organisational requirements
 - Product governance
 - PRIIPs Regulation
 - Business conduct
 - New rules about IMD (Insurance Mediation Directive)
 - Conflict of interest and Inducements
 - Strengthen requirements of suitability and appropriateness
 - Independent advisory services' rules
 - Improve staff's competencies

Market Structure Framework

Way back in 2007, when MiFID I was introduced, the market structure was classified through a binary model; on one side there were the regulated trading venues category composed by Regulated Market (RM) and Multilateral Trading Facilities (MTF), on the other side there were the Over-the-Counter (OTC) bilateral trades. The fulcrum of this grouping was based on the different mandatory transparency rules.

The recent crisis persuaded the Regulator to renew the market structure through a more critical point of view focusing the revision on a deeper regulatory framework³³. Approximately ten years later the launch of MiFID I came afloat the limits of the old directive probably due to the creation of new hybrid trading system like broking crossing network³⁴, the opportunity to trade on non-regulated market, the ongoing technology revolution with the introduction of new trading system based on algorithm (i.e Algo-Trading and High Frequency Trading)³⁵.

The innovations introduced by Directive 2014/65/UE and Regulation 600/2014/UE in the stream of market structure are certainly worthy of note. The main purpose of the new legislation package was to promote and support the execution of negotiation within regulated trading systems among regulated market (RM), Multilateral Trading Facilities (MTF) and Organized Trading Facilities (OTF)³⁶. This structural change was firstly necessary related to the ongoing progress of technology and secondly, the Regulator has sought to improve the competition supporting the access to regulated facilities.

OTF, introduced by MiFID II, are multilateral system in which multiple third-parties can buy or sell structured finance products, interests in bonds, emission allowances and derivatives (only non-equity instruments). The structure of the definition is deliberately wide³⁷ in order to gather all the negotiation that are not in compliance with the restrictions requested for a regulated market or for a MTF; only an exception is contemplated and concerns ad hoc bilateral trading parties which are not located on organised venues. This peculiarity has allowed to reduce the unregulated transactions improving the transparency's relationship between trading venues and market³⁸. All the features concerning OTF are disciplined in the provisions of Title II of the MiFID II Directive and this new trading venue is classified as an investment service. There are some important peculiarities that represents distinctive elements of investment firms operating OTF; they can firstly act with discretion in the phase of place and retract order and in

³³ Moloney N., *"MiFID II: Reshaping the Perimeter of EU Trading Market Regulation"*, 6 Law & Fin. Mkt. Rev. 327, 2012.

³⁴ Broking Crossing Network are internal system in banks or investment firms through which are matched buying and selling orders of financial instruments with the use of electronic system. They are characterized by a very high degree of automatism in the execution process which assures impartiality and neutrality. For a deeper analysis see Annunziata F., *"Il fenomeno "ibrido" dei crossing system: una valutazione alla luce dell'attuale normative e nell'ottica della riforma MiFID II"*, Maggio 2014.

³⁵ Di Nella L., *"Features of the New Financial Markets Law (MIFID 2 AND MIFIR)"*, 15 in *Revista Brasileira Direito Civil* 119, 2018.

³⁶ For a deeper analysis of trading options post MiFID II and MiFIR see the tab below from *"MiFID 2.0: Casting New Light on Europe's Capital Markets"*, Pierre Francotte, Diego Valiante and Karel Lannoo, report of the ECMI-CEPS task force on the MiFID review.

³⁷ Parziale A., *"La proposta di riforma MiFID II ed il suo impatto sulla disciplina delle trading venues"*, in *"Crisi dei mercati finanziari e corporate governance: poteri dei soci e tutela del risparmio a cura di Lener R.*, in *i Saggi di Minerva Bancaria*, pp. 331-366.

³⁸ Bertis De Marinis G., *"Regolamentazione del mercato finanziario e principio di trasparenza"*, in *Responsabilita' Civile e Previdenza*, fasc.3, p. 0991B, 2016.

the matching phase, secondly the financial institutions have to need a permission to operate an OTF and thirdly, one of the most relevant peculiarity, concerns the limit number of asset classes that can be negotiated on an Organised Trading Facilities (in fact, should be noted that on a OTF is denied the trading of shares and similar products)³⁹. In order to ensure a sounder and genuine trading system, the legislator has introduced more stringent measure of trade transparency obligations and access requirements as well as the commitment with respect to the investor protection provisions explained in article 24 (information to client), article 25 (suitability rule), article 27 (best execution), article 28 (order handling) of MiFID II. It is necessary to highlight that all obligations about transparency and surveillance rules, typical of MTF and regulated market, are also applied to OTF. The main goal the Regulator wants to reach through the introduction of OTF is to limit as much as possible the over-the-counter transactions (scholars are estimated that around 38% of total trading belongs to “dark” trading)⁴⁰.

Other than the introduction of the new type of trading facility, some other rules must be kept into consideration for a detailed analysis of the wider structural change concerning the market structure. Systematic Internaliser (SI) are not considered trading venues anymore⁴¹; it is a counterparty that on an organised, frequent, systematic and substantial basis deals on own account which operates a bilateral system and can't bring together third-party orders⁴².

The other relevant rules introduced for the purpose of ameliorating the breach of the old directive will be illustrated in the subsequent paragraphs.

³⁹ Marin F., *“MiFID regulation of trading venues as a step forward in the path towards the Capital Markets Union”*, Rivista Trimestrale di Diritto dell'Economia, Gennaio 2018.

⁴⁰ Moloney N., *“MiFID II: Reshaping the Perimeter of EU Trading Market Regulation”*, 6 Law & Fin. Mkt. Rev. 327, 2012.

⁴¹ For a deeper analysis see Ghielmi C., *“Le sedi di negoziazione nell'ambito della disciplina MiFID II e MiFIR”*, in Rivista di Diritto Bancario, Aprile 2015

⁴² Art. 4 (1), Recital 20 of Directive 2014/65/EU of the European Parliament and of the Council.

Features	TRADING OPTIONS POST MIFID II/R									
	Regulated Markets		Multilateral Trading Facilities		Organised trading facilities (NEW)		Systematic internaliser (EXPANDED)		Over-the-counter (RESTRICTED)	
Type of trading	Multilateral		Multilateral		Multilateral		Bilateral		Bilateral	
Operator discretion allowed	NO		NO		YES		YES		N/A	
Proprietary capital deployment allowed	NO		NO		LIMITED illiquid sovereign bonds and matched principal trading		YES		N/A	
Pre-trade transparency	Equities	Non-equities	Equities	Non-equities	Equities (not permitted)	Non-equities	Equities	Non-equities	Equities	Non-equities
	YES – Waiver regime now restricted	YES – NEW Calibration/waivers	YES – Waiver regime now restricted	YES – NEW Calibration/waivers	N/A	YES – NEW Calibration/waivers	Yes (no change from MiFID I)	YES – NEW Calibration/waivers	N/A	N/A
Post-trade transparency	YES (minimal change from MiFID I)	YES – NEW With deferrals	YES (minimal change from MiFID I)	YES-NEW With deferrals	N/A	YES-NEW With deferrals	YES (minimal change from MiFID I)	YES-NEW With deferrals	YES (minimal change from MiFID I)	YES-NEW With deferrals

Transparency and transaction reporting

The growing fragmentation of the markets and the increasingly massive diffusion of over-the-counter operations persuaded the European Commission to renew the legislative framework regarding the transparency regime and the transaction reporting obligations.⁴³

The revamping of the Markets in Financial Instrument Directive disciplines important changes in order to reduce the opaqueness of trades; the concept of transparency assumes two different meaning referred to the relationship intermediary/client on one hand and trading venues/market on the other. These issues however are both linked to the investor protection area that remains the cornerstone of the new discipline. In this paragraph, the attention will be focused on the second sense of the concept⁴⁴. Initially, in relation to MiFID I Directive, the transparency requirements concerned only shares tradable on regulated markets; as a consequence of this, the new directive aimed at improving the transparency regimes for both equity-like and non-equity financial instruments, which are exchanged on MTF and OTF on one side, and on the over-the-counter transactions on the other side.

In fact, in an open and competitive financial market, the need to implement a deeper regulation about transparency regime is out of the question if the main goal is a better investor protection;

⁴³ Bernard C. “*MiFID II: The New Transparency Regime*”, March 2014.

⁴⁴ Bertis De Marinis G. “*Regolamentazione del mercato finanziario e principio di trasparenza*”, in Responsabilità Civile e Previdenza, fasc.3, p. 0991B, 2016.

in other words, to obtain a correct price discovery process and a sounder trading system is necessary a strong transparency regime.

The previous directive had attempted to improve the safety of the market in the field of transparency but leaving aside a detailed regulation of OTC transactions directly correlated with the well-known derivatives contract on subprime mortgages. In addition, a series of legislative holes in the regulation, among which the most relevant concerned “dark pool”, broking crossing system, some important limits in the application of rule (only to share so far) and a weak data system reporting, had harmed the price discovery system and hampered the market equilibrium. The new regulation, in particular, disciplines pre-trade transparency rules for equity, equity-like instruments (more precisely shares, depositary receipts, ETFs, certificates and other similar financial instruments) and non-equity instruments (bonds, Structured finance products, emission allowances and derivatives) respectively in article 3 and article 6 of MiFIR stating that market operators “shall make public current bid and offer prices and the depth of trading interests at those prices which are advertised through their system”⁴⁵.

A very similar structure is provided by MiFIR to define post-trade transparency obligations in article 8 and article 10 stating that “market operators and investment firms operating a trading venue shall make public the price, volume and time of the transactions executed” respectively for equity and non-equity instruments.⁴⁶

Following this structure, the Regulator has attempted to align the rules involving equity and non-equity instruments introducing only some distinction in term of transparency obligations basing on the different trading system employed by investment firms (order-driven or quote-driven).

After a preliminary implementation of a strong transparency regime, the other fundamental step in order to reach a higher level of information to client is obviously an efficient spread system of information⁴⁷. MiFIR disciplines transaction reporting obligations in article 12 and article 13 in chapter 3 stating that trading venues must provide pre- and post-trade information separately to the public in a manner that it is on a reasonable commercial basis, with a non-discriminatory access and free of charge 15 minutes after publication.

⁴⁵ Art. 3 and Art. 6 regarding pre-trade transparency obligations of Regulation (EU) No 600/2014 of the European Parliament and of the Council of 14 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012, 12/6/2014, Official journal of the European Union.

⁴⁶ Art. 8 and Art. 10 regarding post-trade transparency obligations of Regulation (EU) No 600/2014 of the European Parliament and of the Council of 14 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012, 12/6/2014, Official journal of the European Union.

⁴⁷ Bertis de Marinis G. “*La nuova trasparenza PRE e POST negoziale alla luce della direttiva MiFID e del regolamento MiFIR*”, in “*La MiFID II, rapporti con la clientela, regole di governance, mercati*”, pp. 287-311, a cura di Troiano V., Motroni R.

Therefore, investment firms, in according with the new legislative framework⁴⁸ concerning data reporting services, that conclude transactions shall make public some information through an APA (Approved Publication Arrangement), ARM (Approved Reporting Mechanism) and CTP (Consolidated Tape Provider).

- APA are market operators entitled to publish report of concluded transactions on behalf of investment firms pursuant to article 20 and article 21 of Regulation (EU) No. 600/2014 and about equity, equity-like and non-equity instruments;
- ARM are market operators entitled to report details of concluded transactions to competent authorities and ESMA on behalf of investment firms;
- CTP are market operators entitled to provide the service of gathering trade reports for specific financial instruments (listed in articles 6, 7, 10, 12, 12, 20 and 21 of Regulation (EU) No. 600/2014) from Regulated Markets, MTF, OTF and APA and combining them into an uninterrupted electronic live data stream to ESMA and competent authorities on behalf of investment firms⁴⁹.

In this way, the overhaul legislative framework regarding transparency regime could play a central role in the creation of a safer financial market.

As a result of the telematic and informatic technologic progress, in the last two decades, there was the creation of new trading systems and techniques named Algo-Trading and High Frequency Trading threatening the market's stability⁵⁰; scholars consider HFT responsible for idiosyncratic shock⁵¹, volatility of financial instruments, price manipulation and liquidity and transparency problems⁵².

The growth of this alternatives techniques is increasing constantly and in particular, estimated data of recent studies (P. Gomber, B. Arndt, T. Uhle 2011) have demonstrated that in Europe the exchanges based on HFT fluctuate between 19 and 40% with respect to the total flow of

⁴⁸ Art. 4 (1), p. 52, 53,54 of Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, 12/06/2014, Official Journal of the European Union.

⁴⁹ Scacchi F., Zaghini G. “*MiFID II. I servizi di comunicazione dati: APA, ARM, CTP*”, in Rivista di Diritto Bancario, Settembre 2015.

⁵⁰ Cialella G., “*Describing and regulating high-frequency trading: a European perspective*”, in “The Handbook of High Frequency Trading”, pp. 95-110, a cura di Gregoriou G., 2015.

⁵¹ Idiosyncratic risk, also referred to as unsystematic risk, is the risk that is endemic to a particular asset such as a stock and not a whole investment portfolio. Being the opposite of systematic risk (the overall risk that affects all assets, like fluctuations in the stock market or interest rates), Idiosyncratic risk can be mitigated through diversification in an investment portfolio.

⁵² Mezzacapo S. “*La regolamentazione dell'Algorithmic trading nell'UE*”, in “La MiFID II, rapporti con la clientela, regole di governance, mercati”, pp. 341-379, a cura di Troiano V., Motroni R.

trades, while in USA between 40 and 70%⁵³. The Regulator has decided to introduce some systemic and operation requirements⁵⁴ that discipline HFT on MiFID II⁵⁵ so as to guarantee a correct functioning of the market; any firms that exploit Algo-trading techniques indeed, must have in place an effective system and risk controls appropriated. Even in this field, the new legislative packaged and the correlated new obligations about HFT, are introduced for the purpose of protecting the investor confidence.

Supervision

The ongoing evolution of European banking supervision originates from the subprime mortgages disaster in 2007 and the following Lehman Brothers default in 2008 digging up the weakness of the harmonized banking supervision⁵⁶. Among the most relevant intervention there was the creation of ESFS⁵⁷⁵⁸ composed by EBA⁵⁹, ESMA⁶⁰, EIOPA⁶¹ and ESRB⁶².

The strengthening of the supervision system led to a deeper and wider control of the correct functioning of the market by supervisory authorities that was supplemented with a recent regulation known as product intervention. The term “Product Intervention”, introduced by Regulation n. 600/2014⁶³, is referred to the supervision power of the financial product split between national (NCAs) and supranational authorities (ESMA and EBA). They are entitled to limit or deny the diffusion, marketing and sale of potentially harmful financial products or structured deposits⁶⁴ that could have negative effect on the stability and integrity of the market

⁵³Alvaro S., Ventrizzo M., ““*High-frequency trading*”: note per una discussione”, in Banca Impresa Società/a. xxxv, n. 3, 2016.

⁵⁴ Leonard C., Zahabi E., Poon C., “*Common market, common rulebook?*”, 34 Int'l Fin. L. Rev. 32, 2015.

⁵⁵ Recital 59,60 of Directive 2014/65/EU of the European Parliament and of the Council.

⁵⁶ Montedoro G., “*Poteri di intervento delle autorità europee e giustiziabilità*”, in “La MiFID II, rapporti con la clientela, regole di governance, mercati”, pp. 387-395, a cura di Troiano V., Motroni R.

⁵⁷ European System of Financial Supervisions (ESFS) is the framework for financial supervision in European Union created in 2011.

⁵⁸ Regulation (EU) n. 1092/2010, n. 1093/2010, n. 1094/2010, n. 1095/2010.

⁵⁹ European Banking Authority (EBA) is responsible for the supervision of banking system since 2011 created by Regulation (EU) n. 1093/2010.

⁶⁰ European Securities and Markets Authorities (ESMA) is responsible for the supervision of European financial market since 2011 created by the Regulation n. 1095/2010.

⁶¹ European Insurance and Occupational Pensions Authority (EIOPA) is responsible for the supervision of European assurance market and occupational pension schemes since 2011 created by the Regulation n. 1094/2010.

⁶² European Systemic Risk Board (ESRB) is responsible for macro-prudential control in order to prevent or mitigate systemic risk to financial stability in the EU since 2010.

⁶³ These obligations are disciplined in Regulation n. 600/2014, Title VII, art. 39, 40, 41, 42, 43, 44. In details, ch. 1 regulates the supervision power for financial instruments and structured deposits while ch. 2 focuses the attention on derivatives.

⁶⁴ A Structured Deposit is the combination of a deposit and an investment product. The returns on a Structured Deposit may depend on the performance of the underlying investment product - market indices, equities, commodities, interest rates, fixed-income securities, foreign exchange rates, or a combination of these.

and on the investor protection⁶⁵. In particular, MiFIR Regulation⁶⁶ states how and under what conditions a competent authority can intervene prohibiting or restricting the marketing, distribution or sale of certain instruments or activities; a competent authority can take action in precise circumstances:

- a financial instrument, structured deposit or other activities may affect negatively the investor protection or may be a threat for the integrity of stability of the whole financial system or commodity market or at least affect the financial system of a specific member state;
- the legislative requirements applicable to the mentioned instruments and financial activities in the previous point, in accordance with European Union law, are not able to face the risks and in any case a better and more efficient application of these requirements would not be able to face the problem in an efficient way;
- the authority can intervene if it considers the action is proportionate to the risk identified, features and level of sophistication of investors, impacts on investors who may hold it;
- the competent authority has consulted competent authorities of other Member States where the action could have a significant impact;
- the action has no a discriminatory impact with respect to the services or activities provided by another Member State;
- it has consulted public bodies competent for the supervisory, administration and regulation of agricultural markets under Regulation n. 1234/2007⁶⁷ where a financial instrument or activities can represent a threat for the normal functioning and integrity of agricultural markets.

In general, all the actions taken in place by the competent authority aim at preserving the integrity of the market and the investor protection⁶⁸.

An important distinction is needed to keep in mind between powers of NCAs and powers of ESMA and EBA.

⁶⁵ The criteria to define this are summarized in: complexity of product in relation to the client, the degree of innovation of the product, the leverage the product provides and the size or notional value of an issuance of products, Art. 42 (7) in Regulation n. 600/2014.

⁶⁶ Art.42 (2) of Regulation (EU) No. 600/2014 of the European Parliament and of the Council of 15 May 2014.

⁶⁷ Council Regulation (EC) No 1234/2007 of 22 October 2007 establishing a common organisation of agricultural markets and on specific provisions for certain agricultural products (Single CMO Regulation).

⁶⁸ Capriglione F., “*Prime riflessioni sulla MiFID II (tra aspettativa degli investitori e realtà normativa)*”, in “La MiFID II, rapporti con la clientela, regole di governance, mercati”, pp. 171-210, a cura di Troiano V., Motroni R.

The intervention is the task of NCAs primary and then of ESMA and EBA in the event that national authorities have not taken in place some measures or in case the measures adopted are not sufficiently suitable to solve the problem⁶⁹; hence ESMA (for financial instruments) and EBA (for structured deposits) cover a coordination role in relation to actions taken by NCAs ensuring that those actions are correct, efficient and proportionate⁷⁰.

Product intervention can be considered as a complementary rule⁷¹ of product governance because the Regulator has decided to introduce these two provisions both with the aim at improving investor protection⁷².

The harmonization of the supervision system is not a simple target because requires an efficient cooperation among authorities and for this reason is surely considered a far-reaching goal, but it is another fundamental step towards a better investor protection.

Commodity derivatives

In addition to the believes that market efficiency is based on successful behavioural and transparency rules, after the financial crisis, it started to spread the idea that the quality of instruments exchanged represents another important pillar for the correct functioning of the market⁷³. MiFID II, through the implementation of product governance and product intervention, provides to authorities some new techniques to steer derivatives market towards an upper level of resiliency. Moreover, in particular, MiFID II and MiFIR intervene on commodity derivatives⁷⁴ improving transparency in the market and attempting to limit speculation activities restricting the maximum number of positions taken in the abovementioned financial instruments.

These tools of intervention have marked the legislative framework representing a breakthrough with respect to the previous regulatory policy that was not able to manage the intrinsic riskiness of derivative contracts. Through the application of the new MiFID II the legislator has decided to widen the number of instruments subject to the discipline, restricting the exemption (in order to reduce the speculation) and limiting the position adopted that doesn't have hedging

⁶⁹ Guarracino F., *"I poteri di intervento sui prodotti finanziari (la c.d. product intervention)"*, in *"La MiFID II, rapporti con la clientela, regole di governance, mercati"*, pp.231-260, a cura di Troiano V., Motroni R.

⁷⁰ Busch D., *"Product governance and product intervention under MiFID II/MiFIR"*, in *"Regulation of the EU Financial Markets: MiFID II and MiFIR"*, Oxford University Press, pp. 123-146, a cura di Busch D., Ferrarini G., 2017.

⁷¹ Recital 29 of Regulation (EU) n. 600/2014.

⁷² Sesti G., *"Going further on investors' protection: product governance, product intervention and the role of ESMA"*, In *Rivista Trimestrale di Diritto dell'Economia*, Gennaio 2016.

⁷³ Lemma V., *"La sicurezza degli strumenti finanziari derivati dopo le nuove definizioni della MiFID II"*, in *"La MiFID II, rapporti con la clientela, regole di governance, mercati"*, pp. 327-337, a cura di Troiano V., Motroni R.

⁷⁴ The application of the definitions in Sections C6 and C7 of Annex I of Directive 2004/39/EC (MiFID), Guidelines of ESMA.

purpose⁷⁵. In general, the intervention of the Regulator through the MiFID review (introduction of product intervention)⁷⁶, the EMIR⁷⁷ Regulation and MiFIR Regulation allowed to major operation in particular on OTC market that by definition it is ever more affected by opaqueness.

Non-EU investment firms

The access of third-country firms to the EU markets was not harmonised under MiFID I. Going to a strong harmonisation of European regulatory framework, MiFID II has introduced a regime concerning the access of third-country to the European market based on a qualitative equivalence assessment conducted by the Commission⁷⁸. The new regime will be applied in the supply of cross-border investment services and activities only respect to professional investor or eligible counterparties. In a period of three years and during the assessment process remains into force national dispositions that regulate the market access for intermediaries of third-countries⁷⁹. Once the Commission has decided an equivalence measure and ESMA has established cooperation arrangement with third-country authorities and, after an application with ESMA, the non-EU investment firms can provide services to professional clients and eligible counterparties without establishing a branch in a Member State; otherwise third-country firm can operate in Member State under the national regime and without exploit EU passport. On the contrary, for services provided to retail clients by a third-country firm, Member States will continue to adopt national dispositions⁸⁰. An important issue to take into consideration regards the provision that states MiFID II is not applied when investment services are supplied with the initiative of EU clients.

Investor protection

The investor protection is the core of MiFID II that attempts to broaden all provisions concerning investment services and introducing high-level obligations. The new rulebook increases the study of each service in relation to client classification and includes conduct of business requirements (aims at improving investor protection and market efficiency) and organisational requirements (aims at strengthening market integrity and resiliency).

⁷⁵ Alibrandi Sciarone A., Grossule E., “*MiFID II e commodity derivatives*”, in “La MiFID II, rapporti con la clientela, regole di governance, mercati”, pp. 495-512, a cura di Troiano V., Motroni R.

⁷⁶ A specific provision about derivatives is disciplined in Regulation (EU) n. 600/2014 in Art. 42, Par. 2.

⁷⁷ European Market Infrastructure Regulation (EMIR) is an institution for the regulation of over-the-counter derivatives since 2012.

⁷⁸ Bonante G., Gallicchio M., “*MiFID 2 e MiFIR, recenti sviluppi*”, in Rivista di Diritto Bancario, Febbraio 2014.

⁷⁹ Di Nella L., “*Features of the New Financial Markets Law (MIFID 2 AND MIFIR)*”, 15 in Revista Brasileira Direito Civil 119, 2018.

⁸⁰ “*Markets in Financial Instruments Directive (MiFID II): frequently asked questions*”, Memo European Commission, 15 April 2014.

Investment services can be affected by⁸¹:

- asymmetric information due to limited financial education and private information detected by investment firms;
- high switching costs and sunk costs derived by the difference in knowledge between parties;
- bias in decision-making process that affect investor; in particular it refers to “cognitive bias” derived from the behaviour of retail investors that often violate the rationality and economic principles.

MiFID II⁸² aims at improving investor protection with the implementation of some measures:

- General behavioural principles, so when investment firms provide investment services or ancillary services, they have to act honestly, fairly and in the best interest of client; they then provide appropriate, correct and comprehensible information in a good time.
- Regulation of information about financial products and costs; the information shall be appropriate, correct and comprehensible.
- It is now required the records of all telephone conversations and electronic communications for some type of services.
- Product governance represents one of the most relevant innovation in MiFID II and it consists in a discipline that regulates both the entire market system, investment firm/client relationship and manufacturer/distributor cooperation. This investor protection provision ensures that financial products have a high degree of compatibility with each group of clients (target market) from the manufacturing process to the distribution process. It is requested in this way a restyling of the investment firm’s organisation⁸³. The theme will be considered in a deeper manner in chapter three.
- Important innovations are taken in place in the field of independent advice that complements the classical advisory process. Each investment firm can choose the type of advice but with a previous communication to the client explaining if it is a classical or independent advice to guarantee the maximum level of transparency⁸⁴. In order to

⁸¹ “*MiFID 2.0: Casting New Light on Europe’s Capital Markets*”, Pierre Francotte, Diego Valiante and Karel Lannoo, report of the ECMI-CEPS task force on the MiFID review.

⁸² Art. 24, Section 2 of Directive 2014/65/EU of the European Parliament and of the Council.

⁸³ Di Nella L., “Features of the New Financial Markets Law (MIFID 2 AND MIFIR)”, 15 in *Revista Brasileira Direito Civil* 119, 2018.

⁸⁴ Pezzuto E., Razzante R., “*Finalità e contenuti della direttiva 2014/65/UE (MiFID II) e del regolamento (UE) n. 600/2014 (MiFIR)*”, in “MiFID II: le novità del mercato finanziario”, Ch. 1.

comply with new legislation, the independent advice process is based on an offer of a wide set of diversified financial products and without any inducements⁸⁵. The investor can properly choose financial products through a careful support and fruitful relationship with a skilled advisor who will act as a guide in each phase⁸⁶.

- Strengthen requirements of suitability and appropriateness: in the transparency relationship between intermediary and client there is a double side of analysis: the process of information to client and the process of information received from the client (know your customer rules). This latter process is strictly linked to suitability rule, in fact the operations acted by the client should be suitable based on investment services offered by intermediaries; the suitability procedure, as reported in art. 25 (2), is requested for investment advice and portfolio management. The strengthening of suitability rule is driven by the fact that the investment firm, in the offer of these services, has a relevant active role⁸⁷; following these obligations, the investment firm supplying these services must obtain client's knowledge and experience, client's financial situation, the capacity to bear losses and client's investment objectives, and in addition it shall communicate to client if it will provide a periodic assessment about suitability of services.

Appropriateness rules is referred to art. 25 (3) of MiFID II but it is not a real restyling of the previous regime; it is applied to all other services excluding investment advice and portfolio management. The main difference with respect to suitability rule regards the information set requested by banks in order to provide these type of services; in general appropriateness obligations are less stringent⁸⁸ in term of gathering information process than suitability obligations.

- PRIIPs stands for Packaged Retail and Insurance-Based Investment Products; the value of these types of financial instruments is correlated with a lot of disparate market variables or underlying activities. The PRIIPs Regulation was introduced from January 2018⁸⁹ for the purpose of increasing transparency; a useful tool created in order to improve transparency and investor protection is the key information document (KID), that allows investor to make a simple comparison with other financial products. This

⁸⁵ Recital 72 and 73 of Directive n. 2014/65/UE of the European Parliament and of the Council.

⁸⁶ Capriglione F., "*Prime riflessioni sulla MiFID II (tra aspettative degli investitori e realtà normativa)*", in "La MiFID II, rapporti con la clientela, regole di governance, mercati", pp. 171-210, a cura di Troiano V., Motroni R.

⁸⁷ Colombo C., "*Adeguatezza, appropriatezza e mera esecuzione nell'offerta di servizi di investimento*", in "La MiFID II, rapporti con la clientela, regole di governance, mercati", pp. 57-80, a cura di Troiano V., Motroni R.

⁸⁸ Information to be collected for purpose of assessing appropriateness regards only client's knowledge and experience.

⁸⁹ Regulation (EU) n. 1286/2014 of European Parliament and the Council of 26 November 2014.

concise and investor-friendly pre-contractual document should support retail clients towards the best choice through a series of parameters like market risk, liquidity risk, credit risk, costs/benefits and performance scenarios of simple comprehensibility⁹⁰. The argument will be explained later in the following chapter in a more detailed manner.

- The new legislative packaged aimed at improving, inter alia, the intermediary's discipline correcting the flaws of the previous directive; in compliance with new directive, the investment firm has to follow all steps for preventing possible conflicts of interest⁹¹; in case of the investment firm is not able to avoid the problem, it shall disclose to client the nature of the conflict of interest and all reasonable measures to mitigate it before undertaking business⁹².

An interesting point regards the switch of some textual specification (in the Italian MiFID II translation), in fact in the new directive the verb “manage” (“gestire” in the Italian text of MiFID II) in relation to conflict of interest is replaced by the verb “prevent” (“prevenire”) that represents a stronger requirement transferred to intermediaries⁹³.

The other turbulent theme, strictly related to conflict of interest, that MiFID II attempts to regulate is the theme of inducements⁹⁴. The new provisions regard, in particular, investment advice, portfolio management and the supply of other investment services; there are two types of inducements, monetary benefits and non-monetary benefits and two distinct classes of services that require different obligations, namely independent investment advice and portfolio management on one side and other investment services on the other. The Directive lays down that any inducements is forbidden except for⁹⁵ the second class of services for which are allowed inducements only if they increase the quality of the service and if doesn't damage the procedure of the investment firm to act honestly, fairly and professionally in the best client's interest⁹⁶. In the case that inducements are allowed, the investment firm has to communicate to client the existence, the essence, the size of payment and the methodology⁹⁷.

⁹⁰Bonante G., Lener F., “Cosa sono i KID dei PRIIPs?”, in Financial Community Hub, 2016.

⁹¹ Recital 56 and Art. 16 (3) of Directive 2014/65/EU of the European Parliament and the Council of the 15 May 2014.

⁹² Art. 23 of Directive 2014/65/EU of the European Parliament and the Council of the 15 May 2014.

⁹³ Ginevri Sacco A., “Il conflitto di interessi fra intermediari finanziari e clienti nella MiFID II”, in “La MiFID II, rapporti con la clientela, regole di governance, mercati”, pp. 471-490, a cura di Troiano V., Motroni R.

⁹⁴ Art. 24 (7), (8), (9) of Directive 2014/65/UE of the European Parliament and of the Council.

⁹⁵ Art. 24 (9) of Directive n. 2014/65/UE of the European Parliament and of the Council.

⁹⁶ Perrone A., “Tanto rumore per nulla? Per un ripensamento della disciplina sugli inducements”, in Banca Borsa Titoli di Credito, fasc. 2, 2016.

⁹⁷ Di Maio D., Vianelli A., “Ricerca in materia di investimenti e inducements nel regime MiFID II: una lettura critica delle novità regolamentari introdotte”, in Rivista di Diritto Bancario, Aprile 2018.

Chapter Two

Information to Retail Client and Investor Protection

MiFID II, that replaced the previous version (Directive 2004/39/CE), attempts in primis to increase the end client protection through a higher level of transparency, a more accurate information set and more stringent obligations for intermediaries. The most relevant tools, through which the new directive wants to reach a better investor protection framework, are the product intervention and product governance rules, the conflict of interest regime and a more accurate training staff system for intermediaries. In term of transparency, the main innovation in favour of the end client are the introduction of a rigorous costs system (including costs and fees of investment and ancillary services and the cost of financial product)⁹⁸ and an easy but detailed information document (from January 2018 there is in addition the KID document). All the new provisions were created with the final goal to offer to investors a sounder and safer financial environment; in order to reach this goal, the Regulator has developed a series of legislative tools, among which the most important have been illustrated in the previous chapter, exploited as a means of restoring investor confidence. Even the tools that don't affect directly the investor protection, they will probably have, in any case, an effect of end client through their influence of other factors.

2.1 Product Governance Overview

MiFID II has introduced with Product Governance regime, a set of obligations for intermediaries requiring a specific organizational system and rigorous behavioural rules related to the creation, supply, distribution of financial products to end client; these new rules represent a transformation in the construction and in the development of investor protection⁹⁹. The Regulator has decided to introduce a new regime because the sale of inadequate financial products is responsible for serious damages affecting the end client and the relationship between him and the intermediary (retail conduct failure) and producing detrimental effect on integrity

⁹⁸Art. 24 (4), point C of Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014.

⁹⁹Sesti G., “*Going further on investors’ protection: product governance, product interevention and the role of ESMA*”, in *Rivista Trimestrale di Diritto dell’Economia*, p. 86, Gennaio 2016.

and stability of the market (market conduct failure)¹⁰⁰. Now the investor protection should not be considered only as strict relationship between intermediary and client, but it has to be considered a step backward in the sense of the procedure is now incorporated and has origin in the internal process of firm; in other words, in virtue of product governance, the end client protection phase is anticipated within the product designing phase¹⁰¹. This provision disciplines the thorough relationship between manufacturer and distributor, the two main players of the product governance process. Investment firm should act in the best interest of client according with the directive's obligations, understand rigorously the product in order to identify the target of clients to whom the investment products will be offered. Member States should ensure that products are tailor-made in accordance with the features of the pre-identified target market, distributed through an adequate distribution strategy and periodically monitored¹⁰².

It's important to bear in mind that the discipline of product governance is considered in addition to conflict of interest regime, suitability, appropriateness and information to client requirements and not only a simple substitution procedure. The obligations of product governance involve all the players acting in the manufacturing and distribution process; in order to comply with these obligations, they must implement a strict cooperation in some relevant phases. The Final Report of ESMA establishes that the staff should have adequate skills to comprehend the relevant factors affecting financial instruments and it should be subject to a training program before the effective creation of the product¹⁰³. During the approval process is necessary an accurate analysis of the financial product with the aim to avoid any risks, conflict of interest or an injury to the market.

It is clear that the investment firms have to reorganize the internal structure in order to respect product governance rules; then ESMA gave to the compliance function a fundamental role namely the supervision, the review and the assessment of product governance obligations for the purpose of preventing or solving any possible risk of failure for the firm to comply to its obligation¹⁰⁴.

The Regulator through the application of product governance rules has attempted to reduce the risk of mis-selling¹⁰⁵ (and in this way improving investor protection level). In the case of the

¹⁰⁰ Sciarrone Alibrandi A., "*Dalla tutela informativa alla product governance: nuove strategie regolatorie dei rapporti tra clientela e intermediari finanziari*", in Rivista della Regolazione dei mercati, Fascicolo 1, 2016.

¹⁰¹ Mocchi F., Facchini J., "*Product governance: le Linee guida ESMA di definizione del target Market*", in Rivista di Diritto Bancario, Luglio 2018.

¹⁰² Recital 71 of Directive 2014/65/EU of the European Parliament and the Council of 15 May.

¹⁰³ Morlino S., "*La product Governance nel nuovo regime MiFID 2*", in Rivista di Diritto Bancario, Aprile 2015.

¹⁰⁴ Sesti G., "*Going further on investors' protection: product governance, product intervention and the role of ESMA*", in Rivista Trimestrale di Diritto dell'Economia, pag. 89, Gennaio 2016.

¹⁰⁵ Febbrajo T., "*“Misselling” di prodotti finanziari. I doveri di buona fede e correttezza in soccorso dei risparmiatori traditi*", in Diritto Civile Contemporaneo, Anno III, numero I, Gennaio/Marzo 2016.

product governance could not provide the expected result, competent authorities can intervene to reduce the diffusion of dangerous financial products.

2.2 PRIIPs Regulation

The Packaged Retail and Insurance-based Investment Product Regulation (PRIIPs Regulation) was introduced on 3rd January 2018 by the European Regulation n. 1286 of November 2014¹⁰⁶. The Regulation is applied to packaged retail investment products and insurance-based investment products and only when such products are sold to retail clients. PRIIPs are products whose value is subject to fluctuations due to the exposure to the performance of underlying assets or other variables. In relation to the former type of product, the term “packaged” is referred to the fact that investors are subject to fluctuations in the market; the investment component means that the product offers a medium-long term capital accumulation that beats risk-free rate.

These types of products are typically sold by banks to retail investors, for example when they want to save for different purposes like purchase a house. In this way PRIIPs can provide a lot of benefits for investor but the degree of complexity and the poor transparency of this products can hamper the regular trend of financial market.

It should be noted that the PRIIPs represent the core of the European retail financial investment and cover a range of products worth around ten thousand billion euros in Europe. For this reason, a simple and synthetic document that guides the investors in their investment choices is necessary.

In order to solve some problems linked with this type of product was introduced the PRIIPs Regulation for the purpose of (i) overcoming the heterogeneity among the legislation of different Member States, (ii) improving the transparency and (iii) the comprehensibility of these products through the insertion of a standardised disclosure document known as Key Information Document (KID). The KID is a three-pages document¹⁰⁷ and attempts to make easier the comprehension of the key features of products as well as the comparison among different financial instruments; for this reason, the KID is a pre-contractual document that must be available before the underwriting phase. It should be delivered to the investor without any payment, in a good time before the conclusion of the negotiation and including the key

¹⁰⁶ Regulation (EU) 1286/2014 of European Parliament and the Council of 26 November 2014.

¹⁰⁷ Möllers T. M. J., “*European legislative practice 2.0: dynamic harmonisation of capital markets law – MiFID II and PRIIP*”, in *Banking & Finance Law Review*, pp.141-176, 2015.

information of the product¹⁰⁸; the following bullet list summarizes the most relevant features provided to retail client¹⁰⁹:

1. market risk, liquidity risk and credit risk assessment; after the evaluation of these risks, the financial product is assigned to one of seven specific classes, namely the Summary Risk Indicator (SRI). Such classification depends on market risk (computed between a range from 1 to 7 and called Market Risk Measure MRM) and credit risk (represented by a scale from 1 to 6 called Credit Quality Step CQS). Then the investment firm has to provide information about the methodology adopted for the calculation of the end risk class and the subsequent explanation of the placement in a specific class. If we take into consideration a classification based on market risk, PRIIPs are divided in 4 groups:
 - PRIIPs that allow losses greater than the invested amount (derivative with a low degree of liquidity);
 - PRIIPs linearly linked with performance of the underlying financial instruments (unit-linked without warranty);
 - PRIIPs not linearly linked with performance of the underlying financial instruments (structured products);
 - PRIIPs that present a value depending on not observable market variables (insurance products with dividends' participation depending on the discretion of insurance company).
2. Performance estimation must consider at least four payoff scenarios that are distressed, unfavourable, moderate and favourable; these scenarios are computed with a crossing calculation among the specific features of instruments, the market conditions and a time period generally included in one, three or five years. The manufacturer could decide to provide a further performance scenario whenever it considers the risks are not clearly represented. If instead the analysis is considering an insurance or derivative product, the investment firm must provide compulsorily an additional scenario (linked with occurrence of the incident in the insurance product case)¹¹⁰.
3. Costs and fees scheme related to the investment service provided¹¹¹.

¹⁰⁸ For a deeper analysis see Art. 8 of Regulation (EU) n. 1286/2014 of European Parliament and the Council of 26 November 2014.

¹⁰⁹ For a deep analysis of KID see Delegated Regulation (EU) 2017/653 of the Commission of 8 March 2017.

¹¹⁰ Bonante G., Lener R., "Cosa sono i KID dei PRIIPs?", in Financial Community Hub, 2016.

¹¹¹ Aleandri M., "Valutazione del rischio di mercato di prodotti tradizionali in gestione separata in base al nuovo regime informativo per i PRIIPs", 6 Dicembre 2016.

4. The objective of investment, the policy and the investment strategy.
5. The description of the underlying assets specifying the degree of liquidity.
6. The description of capital protection mechanism.
7. The disclosure about the possibility of insolvency of the PRIIPs' issuer.
8. All necessary data for a complaint by the client as a consequence of any identified problem.

However, the core of information is composed by the MRM (based on a measure of an index), performance scenarios and risk/rewards scheme which represents financial risk of the product. In fact, it would seem that now the attention of the client is focused mainly on financial risk respect to the specific financial product; it often happens that now the comparison is carried out through the analysis of SRI rather than the analysis of the product considered¹¹². It can represent the transition from a classical information to a numerical information.

The manufacturer of the PRIIP is considered the unique player with a responsibility related to the content of KID; furthermore, in order to assess the accuracy of information, the document should be revised at least annually¹¹³.

The PRIIPs definition comprehends several financial products like convertible bonds, derivatives, structured products, investment funds, structured deposits¹¹⁴ and some insurance products; conversely the definition doesn't include non-life insurance products, some life insurance contracts, structured deposits subject to interest rate fluctuation only, company shares, sovereign bond and pension products.

Manufacturers are responsible for the precision of information presented in the document due to the fact they are the authors of KID; distributors instead must deliver the document in an appropriate time-period in order to allow the client to choose the PRIIP after an accurate comparison with other similar products¹¹⁵.

The PRIIPs Regulation have had a troubled and complicated legislative path which persuaded the Regulator to modify the original regulation through the introduction of new Regulatory Technical standards.

The most relevant innovations regard:

¹¹² Lupoi A., "Il tramonto dell'informazione letterale, l'alba dell'informazione numerica?", in *Rivista di Diritto Bancario*, April 2017.

¹¹³ Valdes M., "PRIIPs: le novità al Key Information Document previste nella consultazione ESMA, EBA ed EIOPA", in *Rivista di Diritto Bancario*.

¹¹⁴ Giuliani G., "I depositi strutturati nella MiFID II", in "La MiFID II, rapporti con la clientela, regole di governance, mercati", pp. 313-326, a cura di Troiano V., Motroni R.

¹¹⁵ Cascinelli F., Sasso F., P., "Il Regolamento PRIIPs. I nuovi RTS e il recepimento in Italia con il D. Lgs. 224/2016", in *Rivista di Diritto Bancario*, Aprile 2016.

- The KID of multi-option products has to be drafted following a specific shape and scheme contents;
- An additional performance scenario representing a distressed situation in order to provide to the client a wider framework;
- The initial disclaimer related to the complexity of the product can be omitted for simple instruments;
- The disclosure of administrative costs in relation to biometric risk¹¹⁶ of insurance products¹¹⁷ namely the impact of the biometric risk premium on the investment's reward and the cost's effect of the biometric risk premium.

The idea behind the introduction of the KID explains that, a simple and standardise information, covers a fundamental role for investors since it motivates them to invest after an accurate study and a comparison among different investment products. This approach it would seem another vital step towards a higher degree of investor protection and a market transparency's improvement. In any case, an important concept to keep in mind is the complementary role of the intermediary; it is important that the intermediary, before providing the KID, have made a precise screening of products to offer to end clients; this, for example, means that the intermediary shouldn't offer to a beginner investor a product with a risk profile equal to 7¹¹⁸.

The PRIIPs Regulation should be analysed accordingly with the provisions of MiFID II and IDD¹¹⁹ for a wider interpretation.

Since the features of MiFID II have been mentioned previously, it is necessary a brief overview of IDD in order to better understand how all these rulesets together form a unique legislative package.

The IDD Directive with the Delegated Regulation 2017/2359¹²⁰ have replaced IMD 1¹²¹ and discipline some obligations about the distribution of specific insurance investment products, rules about conflict of interest regime and inducements, information and suitability

¹¹⁶ Biometric risk includes the risk of death, invalidity and longevity.

¹¹⁷ Art. 2 (4) of Delegated Regulation (EU) of the Commission of 8 March 2018.

¹¹⁸ Menicucci M., "*Finanza comportamentale e scenari probabilistici: brevi riflessioni sul KID*", in Rivista di Diritto Bancario, March 2018.

¹¹⁹ Directive (EU) 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution (recast).

¹²⁰ Commission Delegated Regulation (EU) 2017/2359 of 21 September 2017 supplementing Directive (EU) 2016/97 of the European Parliament and of the Council with regard to information requirements and conduct of business rules applicable to the distribution of insurance-based investment products.

¹²¹ Directive 2002/92/EC of the European Parliament and of the Council of 9 December 2002 on insurance mediation.

requirements¹²² and product governance regime basing on the rules already delineated by MiFID II. In particular, the distribution of insurance investment products is disciplined by the Directive 2016/97 integrated with the Delegated Regulation n. 2017/2359 together considered. The IDD Directive is strictly linked with PRIIPs and MiFID II because insurance products compete with products of other sectors covered by securities regulation (MiFID II) and in this way the negotiations over IDD is directly related to MiFID II and PRIIPs Regulation¹²³. In general, the new IDD has the aim to provide a higher protection of policyholders through a good-quality information set and an honest behaviour of distributors¹²⁴.

¹²² Marino D., Pantaleo A., “*Distribuzione di prodotti di investimento assicurativi: le nuove regole di condotta europee*”, in *Rivista di Diritto Bancario*, Gennaio 2018.

¹²³ Willemaers G. S., “*Client protection on European financial markets-from inform your client to know your product and beyond: an assessment of the PRIIPs Regulation, MiFIDII/MiFIR and IMD 2*”, in *Revue Trimestrielle de Droit Financier*, Vol. 4, no.4, November 2014.

¹²⁴ Lembo M., “*Il nuovo quadro normativo degli inducement e della consulenza tra due differenti discipline: MiFID 2 e IMD 2. Brevi note.*”, in *Rivista di Diritto Bancario*, Gennaio 2018.

For the sake of clarification, an example of PRIIPs KID is presented below; it represents a KID of a non-UCITS investment fund issued by FundWorld Fund Manager Limited.

Sample PRIIPs KID for:
FUNDS



Key Information Document

Purpose

This document provides you with key information about this investment product. It is not marketing material. The information is required by law to help you understand the nature, risks, costs, potential gains and losses of this product and to help you compare it with other products.

» Product

Name: **FundWorld non-UCITS Emerging Markets Equity Fund Class A Acc (Eur)**
 ISIN: FA1234567X
 Manufacturer: FundWorld Fund Managers Limited
 Competent Authority: Central Bank of Ireland
 Contact Details: www.fundworld.ie; call +353 1 2079700 for more information
 This key investor information is accurate as at 31 December 2017.

» What is this product?

Type	This product is a non-UCITS investment fund.
Strategy	This product aims to achieve long term growth on your investment by investing in a diversified equity portfolio based in emerging markets (developing countries) located in Asia, Latin America, Africa and Eastern Europe. The product may use specialist financial techniques (known as derivatives) to manage the funds risk exposures or to manage the fund.
Intended Investor	This product is intended for investors who are prepared to take on a relatively high level of risk of loss to their original capital in order to get a higher potential return, and who plan to stay invested for at least 5 years. It is designed to form part of a portfolio of investments.
Maturity	This product is open ended. However, the Manufacturer reserves the right to close the product, at one month's notice, should assets fall below €1,000,000 at any time one year post launch.

» What are the risks and what could I get in return?

Risk Indicator



The risk indicator assumes you keep the product for 5 years.

The summary risk indicator is a guide to the level of risk of this product compared to other products. It shows how likely it is that the product will lose money because of movements in the markets or because we are not able to pay you.

We have classified this product as 5 out of 7, which is a medium-high risk class. This rates the potential losses from future performance at a medium-high level, and poor market conditions will likely impact the capacity for you to receive a positive return on your investment.

The following are some of the other risks materially relevant to the PRIIPs which are not taken into account in the summary risk indicator:

Emerging markets may have less advanced regulatory and control environments. The fund is exposed to exchange rate volatility, as it holds assets denominated in multiple currencies. See prospectus for overall risk information.

The product does not include any protection from future market performance so you could lose all or some of your investment. If we are not able to pay you what is owed, you could lose your entire investment.

» **What are the risks and what could I get in return? (continued)**

Performance
Scenarios

Investment €10,000		1 year	3 years	5 years (recommended holding period)
Stress scenario	What you might get back after costs	€8,200	€7,234	€7,410
	Average return each year	-18.0%	-10.2%	-5.8%
Unfavourable scenario	What you might get back after costs	€9,200	€8,574	€9,510
	Average return each year	-8.0%	-5.0%	-1.0%
Moderate scenario	What you might get back after costs	€10,300	€10,927	€11,593
	Average return each year	3.0%	3.0%	3.0%
Favourable scenario	What you might get back after costs	€11,000	€12,250	€13,382
	Average return each year	10.0%	7.0%	6.0%

This table shows the money you could get back over the next 5 years (recommended holding period), under different scenarios, assuming that you invest €10,000. The scenarios shown illustrate how your investment could perform. You can compare them with the scenarios of other products. The scenarios presented are an estimate of future performance based on evidence from the past on how the value of this investment varies, and are not an exact indicator. What you get will vary depending on how the market performs and how long you keep the product. The stress scenario shows what you might get back in extreme market circumstances, and it does not take into account the situation where we are not able to pay you.

The figures shown include all the costs of the product itself, but may not include all the costs you pay to your advisor or distributor. The figures do not take into account your personal tax situation, which may also affect how much you get back.

» **What happens if FundWorld Fund Managers Limited is unable to pay out?**

You may face a financial loss should the manufacturer or depository, FundWorld Custodian Limited, default on their obligations. There is no compensation or guarantee scheme in place which may offset, all or any of, this loss.

» **What are the costs?**

The Reduction in Yield (RIY) shows what impact the total costs you pay will have on the investment return you might get. The total costs take into account one-off, ongoing and incidental costs.

The amounts shown here are the cumulative costs of the product itself, for three different holding periods. They include potential exit penalties. The figures assume you invest €10,000. The figures are estimates and may change in the future.

Table 1: Costs over time

The person selling you or advising you about this product may charge you other costs. If so, this person will provide you with information about these costs, and show you the impact that all costs will have on your investment over time.

Investment Scenarios (€10,000)	If you cash in after 1 year	If you cash in after half recommended period of 5 years (after 3 years)	If you cash in At the recommended period of 5 years
Total costs	€350	€650	€950
Impact on return (RIY) per year	3.50%	2.17%	1.90%

» **What are the costs? (continued)**

Table 2: Composition of costs

The table below shows:

- The impact each year of the different types of costs on the investment return you might get at the end of the recommended holding period.
- The meaning of the different cost categories.

One-off costs	Entry costs	0.40%	The impact of the costs you pay when entering your investment. (This is the most you will pay, and you could pay less).
	Exit costs	0.00%	The impact of the costs of exiting your investment when it matures.
Recurring costs	Portfolio transaction costs	0.65%	The impact of the costs of us buying and selling underlying investments for the product.
	Other ongoing costs	0.85%	The impact of the costs that we take each year for managing your investments.
Incidental costs	Performance / other incidental fees	0.00%	This product does not have any performance or other incidental fees.

» **How long should I hold it and can I take my money out early?**

Recommended holding period: 5 years

This product has no required minimum holding period but is designed for long term investment; you should be prepared to stay invested for at least 5 years. You may sell your shares in the product, without penalty, on any day on which the banks are normally open for business in Ireland.

» **How can I complain?**

If you have any complaints about the product or conduct of the manufacturer or the person advising on, or selling the product, you may lodge your complaint in one of three ways:

- You can contact our complaints hotline on +353 1 2079700 who will log your complaint and explain what to do.
- You may log your complaint via our website www.fundworld.ie/complaints
- You may send your complaint in writing to Complaints Department, FundWorld Fund Managers Limited, Dublin 1, Republic of Ireland.

» **Other relevant information**

We are required to provide you with further documentation, such as the product's latest prospectus, annual and semi-annual reports. These documents and other product information are available online at www.fundworld.ie/products.

Source: Fund Assist

Conversely is important to bear in mind that a UCITS¹²⁵ fund is a mutual fund generally safe and well-regulated resulting in a high level of investor protection¹²⁶

¹²⁵ UCITS stand for Undertakings for the Collective Investment of Transferable Securities and is a regulatory framework that aim at harmonizing the management and sale of mutual fund throughout Europe.

¹²⁶ Hazenberg J.J., "Independence and focus of Luxembourg UCITS fund boards", in European Journal of Law and Economics, Vol. 41, Issue 1, pp. 117-155, February 2016.

2.3 MiFID Evolution about Investor Protection

The investor protection is, without any doubt, the backbone of the body of MiFID II. In the global financial market, the end client/consumer covers a fragile role due to deep asymmetric information in respect of the intermediary that affects negatively the relationship. Several facets of asymmetric information may be identified in the economic/financial framework:

- the agency model¹²⁷, namely the relationship between agent and principal, concerns problems of asymmetric information originating in the misbehaviour of the intermediary which operates on behalf of the client¹²⁸;
- the asymmetries originated from the evaluation of complex financial products that are often composed by the union of more “opaque” products;
- the difficult in the assessment of risk/reward factors that affect the value of the product;
- the asymmetries regarding the bargaining power in term of unilateral termination of the contract, modification of the pre-identified conditions and other intrinsic features of the contract;
- the organisational asymmetries and the difficult access to justice¹²⁹.

In this way the investor is not always able to properly understand the features of financial products and the related risks and this problem leads investors to make unaware choices. In fact, the imbalance of the two economic players here considered is not based anymore on the different in bargaining power like in traditional models, but is much more focused on the disparity in the knowledge of financial products: therefor is not sufficient a strong starting knowledge because is necessary a permanent updating of the market trend and all the other variables which can affect the value of financial instruments¹³⁰. The Regulator attempted to solve this disparity through the introduction of a legislative scheme in order to maximize the accessibility of information for clients.

Hence the principal objective is to provide to end clients a wider overview about financial instruments and investment profile allowing them an immediate risk perception¹³¹. Another

¹²⁷ Greco G. L., “*La tutela del risparmiatore alla luce della nuova disciplina di “risoluzione” delle banche*”, in Banca Impresa Società, a. XXXV, n.1, pp. 77-110, 2016.

¹²⁸ Scarpa D., “*Un’analisi economica del diritto: teoria dell’agenzia e rapporto di amministrazione*”, in Altalex, 15 Giugno 2009.

¹²⁹ Calliano O., “*Informazione e trasparenza nei contratti bancari e finanziari tra diritto dei consumatori e nuovo diritto europeo dei servizi bancari e finanziari*”, in Rivista di Diritto Bancario, November 2014.

¹³⁰ Acierio M., “*I diritti dell’investitore nella giurisprudenza di legittimità*”, in Rivista di Diritto Bancario, Novembre 2017.

¹³¹ Greco F., “*Dall’informazione pre-contrattuale alla product governance: la tutela del risparmiatore tra paternalismo normativo e nuovi modelli di controllo*”, in Rivista di Diritto Bancario, October 2017.

important element linked with the necessary revision of investor protection regards the ever-increasing complexity of financial instruments provided by investment firms; the complexity of financial products led to a difficult interpretation for retail clients which doesn't have the necessary financial knowledge.

The reform of policy framework is conducted through the introduction of MiFID II Directive, MiFIR Regulation, Delegated Directive n. 2017/593¹³², a group of Delegated Regulations and some Technical Standards of ESMA with the aim at granting a higher investor protection, overcoming a model focused only on transparency in favour of a model based on concrete customer care¹³³.

In particular MiFID II disciplines investor protection in section II; this section collects provisions to ensure investor protection and it is composed by seven articles.

The first part of this section regards the so-called "general principles and information to clients". Following these obligations, in order to reach a higher degree of investor protection, the investments firms¹³⁴ shall always act in the client's best interest in an honest, fair and professional manner and at the same time they shall provide financial products of which creation and distribution are suitable for a specific target market. The duty to act in accordance with the best interest of client represents the fulcrum of the detailed conduct of business rules within MiFID II and its implementing measures and plays a central role in their interpretation¹³⁵. This phase shall be preceded by an accurate knowledge of the products. The information provided shall be fair, clear and not misleading and in the case of investment firm supply investment advice, it shall communicate if the advice is in independent or traditional form. The advice service is considered independent if are met two conditions: the intermediary offers a broad and diversified range of financial products and the prohibition to receive fees or monetary and non-monetary benefits provided by third-party¹³⁶.

Another important point, disciplined in the investor protection section, regards the information about costs and fees related to the investment service. If the advice is provided in an independent

¹³² Commission Delegated Directive (EU) 2017/593 of 7 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council 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 benefits.

¹³³ Santoro V., "*Crisi bancarie, ruolo dell'informazione e protezione del cliente*", in *Estudios sobre derecho de la insolvencia*, a cura di Bartolomè D. G., Pacchi S., Pèrez del Blanco G., Eolas Ediciones, León, pp.849-858, 2016.

¹³⁴ Investment firm is defined in Art. 4, Par. 1 of Directive 2014/65/EU as: "any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis".

¹³⁵ Enriques L., Gargantini M., "*The expanding boundaries of MiFID's duty to act in the client's best interest: the Italian case*", 3 Italian L.J 485, in the Italian Law Journal, Vol. 03-n. 02, 2017.

¹³⁶ Scolari M., "*Un restyling per la consulenza finanziaria*", in Financial Community Hub, 17 Novembre 2014.

manner or in case of portfolio management, the investment firm shall not accept or retain fees and commissions provided by any third-party in relation to the service supplied to client.

The investment firm could offer a package of products but, in this case, it shall communicate to client if the products can be sold separately indicating costs and risks of any single product.

Member states in exceptional case should impose to investment firm additional requirements but they must be justified in a good manner.

The Commission is entitled to adopt Delegated acts, basing on Art. 89, with the aim at ensuring the respect of requirements stated in Art. 24 of Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014 regarding provisions about information, assessment criteria of products, inducement rules¹³⁷.

The following part of the same section regards the assessment of suitability and appropriateness and reporting to clients.

Member states communicate to investment firms that, who provide investment advice, information or other investment service to client, has the right competences and skills; the investment firm must be able to demonstrate it to authorities on request. In particular, the investment firm providing investment advice or portfolio management¹³⁸ must obtain all necessary information¹³⁹ from client in order to offer a suitable investment service or instrument; otherwise, for all the other investment services, excluded those previously explained, the investment firm must collect all the information useful only to provide an appropriate service. The obligations required for investment advice, for example, are higher than obligations required for other services, because in this case, the retail client leaves a consistent part of his own investment decision to the advisor; hence, the final result of the investment belongs, in a large part, to advisor's professional quality¹⁴⁰.

The suitability rule instead, is applied only to investment advice and portfolio management, where the investor protection requested is higher due to the intrinsic features of these two services, and it is composed by double-phase process: the assessment of suitability includes the phase of knowledge of all characteristics of the client (know your customer rule) through a deep analysis of the features and the gathering information phase of the products (know your merchandise rule)¹⁴¹. In the former phase, under MiFID II there is a major attention on the

¹³⁷ Art. 24, Section II of Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014.

¹³⁸ Final Report – Guidelines on certain aspects of the MiFID II suitability requirements, 28 May 2018.

¹³⁹ Commission Delegated Regulation (EU) 2017/ 565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive.

¹⁴⁰ Hobza M., *“Investment services and protection of the retail client”*, in *The Lawyer Quarterly*, Vol 5, No 1, 2015.

¹⁴¹ Salerno M. E., *“Con la MiFID II nuovi obblighi informative per l’intermediario a tutela dell’investitore”*, in *Financial Community Hub*, 19 Giugno 2017.

quality and the quantity of information; the intermediary, in order to have a broad knowledge of the client, requests the experience and knowledge of the client, the capacity to bear losses, the risk propension in term of risk/reward parameter, and the risk tolerance¹⁴². Regarding knowledge of products, the new Directive requires to all manufacturers and distributors a strong knowledge of the products in order to decide at the origin of the process the perfect matching between client and products and the subsequent distribution strategy. This phase is strictly linked with the innovative product governance regime. This fundamental process should lead to a perfect matching between clients and financial products. In the case of the client doesn't provide a minimum quantity of information to investment firm, the firm must communicate to the client that it is not able to determine the appropriate service or products.

When the investment firm provides investment services like receipt or transmission of order and execution only, it has not to obtain all the information (appropriateness assessment) previously described if some specific conditions are met: the most relevant provisions concern shares or bond traded in regulated market or an equivalent market and that don't embed derivative, money-market instruments excluding those that embed a derivative instruments, share or units in UCITS, excluded structured¹⁴³ UCITS¹⁴⁴, structured deposit excluded complex structured deposit and other not complex financial instruments. In order to avoid the gathering information phase, other than the aforementioned conditions, additional requirements have to be met: in the case of the service is provided at the initiative of client or the investment firm has clearly communicated to the client that these types of services don't request the appropriateness assessment or if investment firms comply with the obligations in Art. 23.

Then, there are other provisions for the investor protection regarding records that includes document concerning all obligations between client and investment firm and reports that investment firm shall provide to client for periodic communications¹⁴⁵.

In the next part, the Directive discipline the provision of services through the medium of another investment firm.

¹⁴² For a broad and detailed explanation see Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive.

¹⁴³ Discussion Paper – ESMA's policy orientations on guidelines for UCITS Exchange-Traded Funds and Structured UCITS.

¹⁴⁴ UCITS that provide investors, at certain predetermined dates, with algorithm-based payoffs that are linked to the performance, or to the realisation of price changes or other conditions, of financial assets, indices, or reference portfolios.

¹⁴⁵ For a deeper analysis see Art.25, Section II of Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014.

Member States then can agree to an investment firm to receive instructions from another investment firm to offer investment services on behalf of a client; here there are two different sides of responsibility: the investment firm which supply the instructions is responsible for the accuracy, suitability and completeness of information provided while the investment firm that receives the information is responsible for service provision and order execution¹⁴⁶.

In the following section, the Directive takes into consideration all the provisions regulating the obligations to execute orders in the most favourable way to the client.

An investment firm shall follow all necessary steps to obtain the best result for its client considering all variables affecting the order execution phase; in a particular case, when investment firm receives specific instructions from client, it shall execute the order following the instructions. In the execution phase, the investment firm shall not receive any remuneration or non-monetary benefits as a consequence of address orders in a specific trading venue which is in contrast to conflict of interest and inducement obligations.

Then, any execution venues shall publish data about prices, costs, speeds and probability of execution relating to the quality of service on that venue annually without the payment of any fee.

For execute orders in the best condition, investment firms shall implement specific mechanism and strategies and then it has to provide to client all appropriate information about execution policy. Member states shall require to investment firm to revise periodically the execution arrangements and execution policy to assess if the strategy lead to the most favourable result yet. The end client, on request, has the right to obtain a demonstration that the investment firm have executed the order in accordance with the execution policy adopted¹⁴⁷.

The best execution is linked with a continuous revision process of conditions by the intermediary in order to assess periodically the validity of the adopted strategy¹⁴⁸. The best execution is based on a wide set of criteria but if we consider the retail client, the best result is correlated with the price of financial instruments and the cost associated to the execution service¹⁴⁹.

Other than provisions about best execution orders, member states shall require to investment firms to execute order in a rapid, fair and efficient manner in relation to other clients' orders or

¹⁴⁶ For a deeper analysis see Art. 26, Section II of Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014.

¹⁴⁷ For a deeper analysis see Art. 27, Section II of Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014.

¹⁴⁸ Capriglione F., "*Varietà dalla trasparenza alla "best execution": il difficile percorso verso il "giusto prezzo"*", in Banca Borsa Titoli di Credito, fasc. 4, p. 475, 2009.

¹⁴⁹ Lannoo K., "*MiFID II and the new market conduct rules for financial intermediaries: will complexity bring transparency?*", in ECMI policy No. 24, May 2017.

respect to the trading interests of the investment firm. This rule is disciplined through the Art. 28, namely client order handling rules¹⁵⁰.

Investment firms can appoint tied agent but they have to comply with some obligations disciplined in the section known as obligations of “investment firms when appointing tied agents”. Tied agents generally are appointed with the aim of promoting or soliciting business, receiving orders, placing financial products or providing advice related to that investment firm. An important thing to keep in mind in this context regards the burden of responsibility of any action conducted by the agent; it remains in the hands of investment firm. Hence, Member States shall require to investment firm to monitor the activities of tied agents in order to assess and guarantee that they continue to comply with Directive’s obligations.

Tied agents have to be registered in the public book only after the evaluation of their knowledge and competence in a specific field¹⁵¹.

In the last article of section II are disciplined transactions executed with eligible counterparties. Investment firms can have an economical relationship with eligible¹⁵² counterparties without comply with articles 24, 25, 27, 28, with the exception of paragraphs 4 and 5 of Art. 24, paragraph 6 of Art. 25 and paragraph 1 of Art. 28.

This article concludes the section of MiFID II concerning provisions to ensure investor protection.

In addition to these new requirements, there is the broadening of the means of transparency; it now represents a necessary tool for the client in the adequate choice of products and investment services.

The transparency sense is expanded towards the intermediary’s activity as well as the classical informative relationship with the client¹⁵³; it is now regards, in other words, all the organisational structure and activities of the intermediary system. The concept of transparency concerns, under the new rulebook, not only the information aspect, but also the conduct rules of the intermediaries in order to remove each possible harmful misbehaviour for the client¹⁵⁴. It seems to be a sort of transition period that highlights the switch of the focus of investor

¹⁵⁰ For a deeper analysis see Art. 28, Section II of Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014.

¹⁵¹ For a deeper analysis see Art. 29, Section II of Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014.

¹⁵² See Art. 30 (2) and (3) of Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014 to have a complete list of eligible counterparties.

¹⁵³ Franza E., “*Gli obblighi dell’intermediario nella distribuzione di prodotti finanziari, alla luce degli orientamenti ESMA e della comunicazione Consob del 22.12.2014*”, in *Rivista di Diritto Bancario*, Marzo 2016.

¹⁵⁴ Mezzasoma L., “*Meritevolezza e trasparenza nei contratti finanziari*”, in *Banca Borsa Titoli di Credito*, fasc.2, p.180, Aprile 2018.

protection from the classical information model to a system based on the direct and preventive action of the intermediary¹⁵⁵.

All the new aforementioned requirements can be evaluated positively; a deeper and sounder relationship between investment firms and clients, based on a higher degree of information, can lead to a more financial stability as well as a more accurate investor protection.

Market transparency and investor protection are the two most important pillars of the new legislative package; through the application of the innovative provisions they will contribute to financial stability and consumer confidence.

The effort to improve investor protection is not only limited to the Section II of MiFID II (provisions to ensure investor protection) that includes only a part of the all innovations regarding investor protection; for the sake of simplicity of the analysis, a list of the main themes discussed in the previous paragraphs are summarized in the following bullet list:

- Assessment of suitability and appropriateness
- Data reporting
- Provisions of services through the medium of another investment firm
- Best execution obligations
- Client order handling rules
- Independent advice
- Conflict of interest and inducements regime
- Obligations of investment firms when appointing tied agents
- Transactions executed with eligible counterparties

However, the abovementioned list is not exhaustive; indeed, for a broad analysis, other rules introduced through the new legislative package are noteworthy.

The Regulator, to complete the discipline about investor protection, has introduced rules among which, the most relevant regard a more detailed client classification, the product governance rules and product intervention regime.

The professional operator, in our analysis the investment firm, has to provide different type of information to clients based on the well-known client categorisation; other than information

¹⁵⁵ La Rocca G., “Sottoscrizione e “forma informativa” nei contratti del mercato finanziario”, in *Rivista di Diritto Bancario*, Giugno 2017.

obligations based on client classification, the quantity and the content of information depend also by the service provided¹⁵⁶.

Client classification represents a core theme in the field of information to clients and protection because each different group of clients is subject to different level of protection and transparency. The client classification under MiFID II is very similar to the previous model in MiFID I although there are some differences. The clients are assigned, after an accurate analysis carried out by the intermediary, to three different group: retail client¹⁵⁷, professional client and eligible counterparties characterized by homogeneous behaviour and features. In general legislator wants to assure a broad stream of information for all clients¹⁵⁸ but in particular increasing the level of information and protection for retail clients.

With regard to retail client class, which is considered the weakest category due to the lack of knowledge, expertise and skills, the information should be provided in a detailed manner including indication of risks through the use of a well-known font size; in any case all information should be delivered in a consistent and updated way; when the information provided regards future performance, the information must not be based on past simulation and must be supported by objective data. In addition to this, the new directive requirements impose analysis of performance scenarios in different market situations considering the nature and risks of financial product included in the analysis.

In relation to professional counterparties¹⁵⁹, the Regulator has decided however to strength the requirements; some of these are similar to those of retail clients: the indication of benefits that must be communicate in relation to potential risks, the information must not minimize important items or warnings and it must be accurate and updated. An investment firm, when dealing with professional counterparties, can limit the flow of information provided except in the case of investment advice and portfolio management service or when are negotiated financial instruments that includes derivative instruments.

If we consider eligible counterparties, the information obligations were not required under MiFID I, while they were disciplined since the introduction of MiFID II regulations. A broad package of information is now requested also when investment firm provides services to eligible counterparties; the most relevant information obligations regard the delivery of information about services, products, investment strategies, execution venues and costs and

¹⁵⁶ Mazzei G., “*Violation of the financial intermediary’s information requirements between invalidity of the contract and contractual liability*”, in *Rivista Trimestrale di Diritto dell’Economia*, January 2018.

¹⁵⁷ Retail client is defined in Art. 4, Point 11 of Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014 and is defined as residual category that is client which are not eligible nor professional client.

¹⁵⁸ Perrone A., “*Servizi di investimento e regole di comportamento. Dalla trasparenza alla fiducia*”, in *Banca Borsa Titoli di Credito*, fasc. 1, p. 31, 2015.

¹⁵⁹ Annex II of Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014.

charges. Even in the case of a relationship with an eligible counterparty¹⁶⁰, the flow of information provided can be limited in specific circumstances.

In general, the introduction of the new legislative package aims at widening the information obligations and allowing the clients to understand the maximum amount of information in order to make a choice as much as possible rational¹⁶¹.

Hence, the client's profiling represents a core theme to stabilise the right level protection just like the old directive stated. The intermediary through standardized questions should be discover the risk profile of the client and then makes a first macro-distinction placing each client in a different cluster. Once decided where a specific client is arranged in one of the three cluster, the intermediary can apply specific rules, provide the right information and assess the suitability or appropriateness of a product. Other than this classical type of categorisation, potential clients can be divided in further two macro-categories: the already known clients and the unknown clients.

About the classical distinction, the client's profiling process shall consist of two different phases¹⁶²: the first one encompasses the inclusion in one of the three cluster and the second in the analysis of knowledge, risk attitude, financial stability and current asset owned. The preliminary categorisation, namely the arrangement in different cluster, has to be carry out to understand if other information is needed or it already represents a thorough basket of data to move towards the negotiation stage¹⁶³.

At the end of the assessment there is not an automatic and rigid classification, but the parties can negotiate together the appropriate category. The investment firm can reclassify the clients shifting them from a category to another and, as consequence of this, it is also modified the level of protection and information needed.

In this context is fundamental the distinction in two sub-classes of the professional clients' category. This distinction recognizes the "per se" professional client, which are those disciplined in Annex II of MiFID II, and the "elective" professional clients¹⁶⁴; the latter category of professional clients represents those clients who are non-professional but require to be treated as professional.

¹⁶⁰ Art. 30 of Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014.

¹⁶¹ Busch D., "*MiFID II: stricter conduct of business rules for investment firms*", in *Capital Markets Law Journal*, vol. 12, iss.3, pp. 340-380, November 2017.

¹⁶² Motroni R., "*La classificazione della clientela nella normativa dei mercati degli strumenti finanziari*", in *Rivista di Diritto dell'Economia, dei Trasporti e dell'Ambiente*, Vol. XIII, 2015.

¹⁶³ Motroni R., "*La profilatura del cliente nella MiFID II*", in "*La MiFID II, rapporti con la clientela, regole di governance, mercati*", pp. 405-423, a cura di Troiano V., Motroni R.

¹⁶⁴ Van Gerven W., Kruithof M., "*A differentiated approach to client protection: the example of MiFID*", in *Society of European Contract Law*, July 2010.

Client categories under MiFID II

Eligible counterparties	'Per Se' professional clients	'Elective' professional clients	Retail clients
Regulated financial institutions, pension funds, governments etc. with whom investment firms are trading (per Article 24 of MiFID).	Clients who fall into one of the categories under Section 1 of Annex II of the MiFID II Directive (regulated financial institutions, large corporate entities, collective investment schemes, government bodies etc.).	Clients who do not fall under Section 1 of Annex II but who request to be treated as a professional client and demonstrate that they meet the financial expertise criteria of Section 2 of Annex II.	All clients who are not professional clients or eligible counterparties.

Source: Dechert LLP

This change of category is not automatic based on a negotiation between the parties, but it must be subjected to an accurate assessment; it consists in a process formed by qualitative, quantitative and procedural criteria¹⁶⁵:

1. Qualitative requirements: this phase consists on an adequate assessment of knowledge, experience and capability that assures, in a reasonable manner, that the client is able to make his own investment decision and understand the risk involved in the operation;
2. Quantitative requirements: a client has to satisfied at least two of the following criteria in order to become a professional counterparty:
 - the client had carried out operations, in a significative size, on the relevant market with at least a frequency of 10 operations per quarter in the last three quarters;
 - the value of portfolio, cash deposit and financial instruments must exceed €500,000;
 - the client works or had worked in the financial sector covering a professional position for at least one year.
3. Procedural requirements:
 - a retail client must communicate in writing form that he wants to be treated as a professional client;

¹⁶⁵ Moloney N., "Investment firms and investment services" in EU securities and financial market regulations, Oxford University Press, Oxford, pp. 352-354, 2014.

- the investment firm has the burden to communicate to client the decreasing level of protection that now the client can exploit;
- client has to communicate in writing form, in a specific document, that he is aware of the protection he is losing and the directly linked consequences.

The stricter conduct-of-business regime was implemented through the new legislative package with the aim to strength contract-related conduct of business rule and limit the misleading behaviour of intermediaries. In this way the Regulator has attempted to reduce the vulnerability of retail client as well as the weaknesses of the other market players.

Such new rulebook aims at limiting the autonomy of retail investors in order to avoid they undertake dangerous financial operations and restricting each possible misleading behaviour of intermediaries towards end clients¹⁶⁶. All this restyle model regarding investor protection is accompanied by other two important innovations introduced, namely product governance and product intervention. These two new regimes are entitled to guarantee the stability of financial system through the protection of investors; product governance rules ensure that each financial instrument is designed and created to match needs, characteristics and objectives of an identified target market of end clients; an important thing to bear in mind is that such regime doesn't run out its function in the manufacturing process. In fact, it is characterized by an intense interaction with the distribution process that has the burden to sell the product to the specific pre-identified¹⁶⁷ target market. This chained process is possible only with a perfect stream of information among the players; the information flow has to be precise, updated and detailed. Hence it is clearly visible that the information represents the foundation also in the phases that precedes the actual sale phase to end client. In addition to the ex-ante product governance rules, the new rulebook has introduced an ex-post provision known as product intervention regime. Member states, through product intervention tools, are entitled to prohibit or restrict the marketing, distribution or sale of some financial products if they could represent a threat to the normal functioning, stability or integrity of financial system as a whole. In this context, product intervention is considered the natural complement tool of product governance rule useful to stem the risks inherent in the increasingly complex financial products¹⁶⁸.

¹⁶⁶ Cherednychenko O. O., “*Contract governance in the EU: conceptualising the relationship between investor protection regulation and private law*”, in *European Law Journal*, Vol. 21, No. 4, pp. 500-520, July 2015.

¹⁶⁷ Colaert V., “*MiFID II in relation to other investor protection regulation: picking up the crumbs of a piecemeal approach*”, October 2016.

¹⁶⁸ Schaecken Willemaers G., “*Product intervention for the protection of retail investors: a European perspective*”, in *Risques, crise financière et gouvernance: colloque transatlantique*, 27 January 2013.

Chapter Three

Product Governance

3.1 Introduction to Product Governance

Product governance, that was introduced through the implementation of the MiFID II package, is probably considered the most innovative discipline in the field of investor protection.

In the legal framework of MiFID II, the manufacturing and distribution process of product are subject to a new discipline; it aims at regulating intra-firm processes and procedures. The financial products considered in this discipline are not limited to shares, bonds and derivative instruments but are also included transferrable securities, money-market instruments, financial contracts and emission allowances¹⁶⁹.

The product governance regime affects the environment both on the side of market regulation and structural organisation of firm and on the side of intermediary/client relationship. It represents the breakthrough for a large part of financial system addressing new rules to several fields.

The product governance provisions aim at regulating all the steps of the investment firms/client chain starting from the introduction of new rules that must regulate the complex phase¹⁷⁰ of product engineering, the subsequent relationship between the manufacturer and distributor, passing through the sale process to the end client up to the final customer care and monitoring in the ex-post selling phase¹⁷¹.

In order to comply with this new regime, the investment firms firstly have to reorganize the internal structure; a sort of suitability assessment is implemented both in the manufacturing and distribution process.

In this way, the product governance imposes to intermediaries a new organisational form and behavioural ruleset in the creation and distribution of financial products. The investment firm, represented by an intermediary in the relationship with the end client, is now obliged to respect

¹⁶⁹ For a deeper analysis about financial instruments included in the product governance discipline see Section C of Annex I of Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014.

¹⁷⁰ Final Report – ESMA’s Technical Advice to the Commission on MiFID II and MiFIR, pp.52-53 of 19 December 2014.

¹⁷¹ Annunziata F., “Servizi e attività di investimento: regole di condotta e di organizzazione interna. I contratti e la separazione patrimoniale”, in *La disciplina del mercato mobiliare*, G. Giappichelli editore, Torino, pp. 156-159, 2015.

precise and rigid rules for the purpose of ameliorating the position of the investor in the financial environment, in term of protection, in a hypothetical hierarchical structure. Hence, once again, the main goal of the Regulator is to restore the investor confidence through a more efficient protection system.

The investor protection is not anymore applied only in the final distribution and selling phase but begins at the origin of the process, entering in this way, in the basis of intermediary's organisational framework.

For what concern an ideal supply chain of financial product, a four-phases process can be identified and regards the conception of the product, the creation, the distribution strategy and the final selling stage. During the period of the old financial legal framework, the attention was focused mainly on the final phase assuring that the financial product offered was fitted with the profile of the client; some evidences asserted that, since the rules were applied only in the final phase (distribution and selling phases), this approach were not able to ensure a good investor protection anymore.

It is possible to state that in the old system, an investment firm could sell each type of product to each category of clients without distinction only in respect to information requirements, transparency obligations and conduct rules and after a communication to the client about the features of the instrument. Now, with the new legislative package, the aim is to ensure that a specific product cannot be sold indistinctly to all categories but only within a pre-identified target market.

Following the old approach, a direct consequence was a lack of attention in the early stages, in particular, in the designing phase that now covers, in the new regime, the starting point in the products' supply chain as to the investor protection.

The ESAs¹⁷², European Supervisory Authorities, have adopted in 2013 a joint position¹⁷³ in theme of product governance and supervision known as Product Oversight and Governance process. The joint position¹⁷⁴¹⁷⁵ is considered a tool through which the authorities can assume a unique vision in cross-sectoral situations; however, each of the supervisory authorities is entitled to apply the rules in their sectorial field. Hence, this new regime is applied by EBA

¹⁷² Joint Position of the European Supervisory Authorities on Manufacturers' Product Oversight and Governance Processes, JC-2013-77.

¹⁷³ Art. 56 of Regulation (EU) 1093/2010 of the European Parliament and the Council of 24 November 2010 establishing a European Supervisory Authority (EBA).

¹⁷⁴ Art. 56 of Regulation (EU) 1095/2010 of the European Parliament and the Council of 24 November 2010 establishing a European Supervisory Authority (ESMA).

¹⁷⁵ Art. 56 of Regulation (EU) 1094/2010 of the European Parliament and the Council of 24 November 2010 establishing a European Supervisory Authority (EIOPA).

through the Art.74 of CRD IV¹⁷⁶ following the EBA Final Report¹⁷⁷ provisions; an analogue process is followed by EIOPA in the insurance sector¹⁷⁸. These principles have played a central role in the MiFID II Directive and within important Opinions¹⁷⁹ adopted by ESMA with respect to the selling of complex products¹⁸⁰.

The new rules of product governance are mandatory for investment firms when they are involved in the manufacturing and distribution process of financial products and which are located in the European Economic Area. More precisely, the new regime is applied to MiFID firms but also the non-MiFID firms are affected indirectly.

The product governance regime can be identified in different legislative context: first of all it can be analysed as intermediaries' organisational rules, that is all the provisions about internal structure, distribution policy, inducement regime and the responsibility's issues; secondly it can be considered as a set of conduct rules that disciplines the activity of intermediation, in particular the relationship between intermediary and end client; then the last but not the least sense of product governance can be included in the meaning of tool, more precisely the means through which the manufacturer and distributor of financial products are directly connected. The latter product governance sense is then divided in other sections of legislation based on the type of investment firm involved (MiFID firm or non-MiFID firm)¹⁸¹.

After the overview of product governance, it is necessary to understand how this chained process operates in detail in order to comprehend how the process represents a very efficient innovation for the investor protection.

¹⁷⁶ The Capital Requirements Directives (CRD) for the financial services industry have introduced a supervisory framework in EU that reflects the Basel II and Basel III ruleset on capital measurement and capital standards; the new CRD IV package was introduced in 2013 and is an updated form of the old CRD and has the aim to transpose into EU law the rules of Basel III. When we talk about CRD IV we refer to EU Directive 2013/36/EU and EU Regulation 575/2013.

¹⁷⁷ Final Report, Guidelines on product oversight and governance arrangements for retail banking products, EBA/GL/205/18 of 15 July 2015.

¹⁷⁸ Consultation Paper on the proposal for preparatory Guidelines on product oversight and governance arrangements by insurance undertakings and insurance distributor, EIOPA-CP-15/008 of 30 October 2015.

¹⁷⁹ Opinion on MiFID practices for firms selling complex products, ESMA/2014/146 of 7 February 2014.

¹⁸⁰ Opinion on Structured Retail Products-Goods practices for product governance arrangements, ESMA/2014/332 of 27 March 2014.

¹⁸¹ Troiano V., "*La Product Governance*", in "*La MiFID II, rapporti con la clientela, regole di governance, mercati*", pp. 213-226, a cura di Troiano V., Motroni R.

3.2 A Deep Analysis of Product Governance Rules and an Insight into Manufacturer and Distributor Legal Framework

From January 3rd, 2018, product governance regime is applied to investment firms, banks, managers of undertakings for collective investment in transferrable securities (UCITS) and alternative investment funds (AIFs) which provide investment services and are established in the Economic European Area. For the sake of clarification, it is useful to bear in mind the sources of legislation around which the product governance framework is implemented. The most relevant sources of legislation are represented by:

- Recital 71 MiFID II¹⁸²
- Article 9 (3) of MiFID II¹⁸³
- Article 16 (3) MiFID II, paragraphs 2-6¹⁸⁴
- Article 24 (2) MiFID II¹⁸⁵
- ESMA's technical advice of 19 December 2014, paragraph 2.7¹⁸⁶
- Delegated Directive 2017/593 adopted by the commission on 7 April 2016, Recitals 15-20 and Art. 9 and Art. 10 of Chapter III (Product Governance Requirements)¹⁸⁷ and ESMA's consultation paper containing draft guidelines on MiFID II product governance requirements of 5 October 2016, primary focus on target market assessment¹⁸⁸.

These product governance provisions are entitled to make safer and sounder all the process regarding the financial product value chain; so, all investment firms that manufacture or distribute financial products are subject to these new obligations. Despite the new regime is directly applied to MiFID firms, that means all the investment firms established in a member states in which MiFID rules are in place, also non-MiFID firms are indirectly affected when:

¹⁸² Recital 71 of Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014.

¹⁸³ Art. 9 of Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014.

¹⁸⁴ Art. 16 of Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014.

¹⁸⁵ Art. 24 of Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014.

¹⁸⁶ Paragraph 2.7, p. 47 of Final Report, ESMA's technical advice to the Commission on MiFID II and MiFIR of 19 December 2014.

¹⁸⁷ Recitals 15-20 and Chapter III of Commission Delegated Directive (EU) 2017/593 of 7 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council 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 benefits.

¹⁸⁸ Consultation Paper, Draft guidelines on MiFID II product governance requirements of 5 October 2016.

- have a cooperation with MiFID firms, more precisely when doing a business with MiFID firm;
- they act as distributor on behalf of MiFID investment firm¹⁸⁹, that is when a firm distributes financial products that are manufactured by MiFID firms.

The relationship between MiFID firms and non-MiFID firms, that is the relationship between manufacturer and distributor which are not subject to the same legislation, represents a thorny theme which requires a deeper analysis and a precise assessment of the information exchanged in the delicate field of privacy. This topic will be faced in the section regarding the cooperation between manufacturer and distributor in which will be examined also the relationship between MiFID firms and non-MiFID firms.

For the purpose of proceeding with the analysis of product governance, in this first part, is useful to highlight how MiFID II has approached the product governance regime; scholars have established that product governance can be viewed through three different perspectives:

1. Corporate governance approach

From the corporate governance perspective, the management body¹⁹⁰ of the investment firm covers an active and central role in the implementation of product governance regime. MiFID II addresses the duty to implement an internal policy to each investment firm. This policy, apparently, must consider the production of financial instruments both in accordance with the risk tolerance of the firm and the needs of clients mainly. In this way the investment firm has the encumbrance to implement, approve and supervise the product governance process in accordance with the dispositions provided by MiFID II. It is obvious that also in this perspective, the obligations are applied both to manufacturer and distributor¹⁹¹. In order to grant the maximum level of control over the process, investment firm have to provide reports to NCAs on request.

2. Investor protection approach

¹⁸⁹ “Product governance rules under EU MiFID II: practical considerations for US-based DCM practitioners in the eurobond market”, in Linklaters, December 2017.

¹⁹⁰ For a deeper analysis of Management body see Art. 9 of Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014.

¹⁹¹ Final Report, ESMA’s Technical Advice to the Commission on MiFID II and MiFIR, 19 December 2014, pp. 56-60, no. 7 and no. 28.

In this approach the central role is covered by investor; more in detail, in the investor protection perspective the main goal consists in the protection of professional and non-professional clients.

Analysing this approach, the attention is focused on the obligations transferred to manufacturers and distributors. Following this perspective, the manufacturers has to comply with some obligations; the most relevant represent the manufacturing of products following the needs, characteristics and objectives of a pre-identified target market¹⁹², the choice of an adequate distribution strategy coherent with the target market, the certainty that the products is effectively sold to the target clients as well as analysis of potential conflicts of interest.

Conversely, in this approach, the distributor has to collect all the necessary information to understand in a deeper way the financial product and then assess if the product involved represents a perfect match with the features of the client. These previous steps ended with a final assessment carried out by investment firm in order to guarantee that the financial product has been actually sold in the best interest of the client and not only in respect to an internal budgeting rule.

3. Organisational approach:

The organisational perspective focuses the attention on the internal process of product governance; the step by step procedure affects booth manufacturers and distributors in their cooperation. In this context, a relevant role is covered by the compliance department that is entitled to guarantee that product governance obligations are implemented and applied within the organisation. The core of this approach, that actually represents all the product governance process, will be analysed in a specific section below.

The product governance regime is directly applied to all MiFID firms in the whole manufacturing and distribution process and when they advise corporate issuers on the launch of new financial instruments. MiFID firms, under these obligations, have to ensure that all financial products are created in order to match precise features of potential end client that are grouped in target classes. The natural complement of the manufacturing phase is the distribution process and also in this case the distribution strategy must be consistent and compatible with the identified target market.

¹⁹² Art. 24 (2), Section II of Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014.

In addition to the other innovations introduced by the new legislative package, the product governance is probably considered one of the most important tool useful to protect investors, with a particular attention to the retail client. The investments carried out by retail clients contribute to finance the economy and then are a useful tool to protect wealth for health, education and retirements needs in case of adverse situations. The strict regulation about product governance should encourage them to invest in European financial markets because they become aware to rely on an organized process of manufacturing and distribution that, in all phases, has the objective to meet the needs of end clients. This system should allow them to make investment choices in a more rational and accurate manner limiting the threats to financial system and the product intervention actions by the authorities¹⁹³.

Through the analysis of the Recital 71 of MiFID II¹⁹⁴, it is possible to outline the general principles of the new regime:

- First of all, it is remarkable the fact that the intermediary must understand in a deeper manner all the products' features both in the supply/recommendation phases, it has to analyse them and then choose an appropriate strategy to identify the target market; so, for example, a very complex product shouldn't be sold to a retail client¹⁹⁵.
- The manufacturer must guarantee that financial products are created and developed to allow a perfect match with the needs, characteristics and objectives of clients and that, the subsequent distribution strategy is suitable to deliver financial instruments to the identified class of end clients. Therefore, manufacturer and distributor, have the duty to assess, on a regular basis, the correct functioning of the process both with respect to the market identification and the expected reward of products.
- In order to assure that financial instruments are offered in the best interest of clients, if the intermediary is not the same player that have manufactured the instruments, it must obtain and comprehend all the information necessary in relation to the approval process, the features of the product and the target market.
- In the case of the intermediary offers or recommend a product created by a non-MiFID firm, it has to use adequate strategy to obtain the information about the product¹⁹⁶.

¹⁹³ Schaeken Willemaers G., “*Client protection on European financial markets – from inform your client to know your product and beyond: an assessment of the PRIIPs Regulation, MiFID II/MiFIR and IMD 2.*”, Revue Trimestrielle de Droit Financier, Vol. 4, no.4, p. 1-32, November 2014.

¹⁹⁴ Recital 71 of Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014.

¹⁹⁵ Greco F., “*Dall’informazione pre-contrattuale alla product governance: la tutela del risparmiatore tra paternalismo normativo e nuovi modelli di controllo*”, in Rivista di Diritto Bancario, October 2017.

¹⁹⁶ Morlino S., “*La Product Governance nel nuovo regime MiFID 2*”, in Rivista di Diritto Bancario, Aprile 2015.

The product governance regime must be considered in addition to and not in substitution of information's obligations, suitability and appropriateness rules, conflict of interest and inducements regime. Other than these rules, the Regulator has introduced product governance regime to assure that investment firms, in the creation and distribution of financial products and structured deposit, act always in the best interest of client during the whole life-cycle of products or services.

The Regulator, through ESMA's Guidelines, aimed at promoting a greater convergence in the implementation and application of the requirements provided by MiFID II.

Hence, in this dissertation, I'll try to illustrate the wide arrangement governing product governance regime, including the related processes, in a detailed manner and grouping the countless provisions through a set of key points:

- ❖ Identification of the target market for financial instruments
 - ❖ Distribution of financial products to the target market
 - ❖ Regular review of financial instrument to ensure that it is reaching the target market
 - ❖ The responsibility of management body
- ❖ **Identification of target market for financial instrument:**

The identification of the target market assumes three stages before the distribution of the product. In this analysis, for the sake of exposition, I have divided the product governance in four main key points. However, in order to be precise as much as possible, it is useful to explain that, before the marketing and distribution stage, are taken in place other procedures namely the identification of the target market, the creation of the financial instrument and the product approval process. In the dissertation these three steps are explained together within this first key point.

The investment firm must have in place an approval process¹⁹⁷ to identify the potential target market for a specific financial product and specify the clients' needs, features and objective that can lead to a perfect match with the instrument. It is possible to define that the product approval process will provide a preliminary identification of target market, the analysis of all factors, variables and risks that can affect such target market and the assessment of the consistency of the distribution strategy.

The product approval process must be conducted before the marketing and distribution process and always in relation to the potential target market; it's worthy of note that, the

¹⁹⁷ Art. 16 (3) of Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014.

product approval process doesn't substitute the suitability and appropriateness tests but represents a distinct procedure. This process, hence, shall identify the target market for a financial product within the relevant category of clients and should ensure that all the relevant variables and risks affecting the target market are evaluated as well as the consistency of the distribution strategy. In particular, the manufacturer should assess the following elements in the product approval process¹⁹⁸:

- it must ensure that all the risks correlated with the identified target market are assessed;
- it must evaluate that the product does not affect negatively the end client and does not represent a threat for the correct functioning and integrity of the market¹⁹⁹;
- it shall assess any possible event of conflict of interest and should avoid any occurrence in which the end client could be negatively affected by a conflict of interest issue;
- the product testing phase, in which the investment firm must provide a scenario analysis, assess the risk of possibility to obtain bad outcomes and define in what cases negative events can occur. Therefore, it shall evaluate the financial instrument under distressed condition (Stress test) that could be represented by²⁰⁰:
 - ◆ counterparty risk or financial problems may occur and affect negatively manufacturing or third party involved in the process;
 - ◆ a market environment deteriorated;
 - ◆ problems in the diffusion of the financial product;
 - ◆ problem in the demand/supply model in which the demand for a specific instrument is higher than expected.
- it must be carried out an assessment analysis that ensures the product meets all the needs and objectives of target market²⁰¹;
- the manufacturer has to assess the charging structure for the financial instrument and evaluate if:

¹⁹⁸ Busch D., "Product Governance and Product Intervention under MiFID II/MiFIR" in "Regulation of the EU Financial Markets: MiFID II and MiFIR", Oxford University Press, pp. 123-146, a cura di Busch D., Ferrarini G., 2017.

¹⁹⁹ Final Report – ESMA's Technical Advice to the Commission on MiFID II and MiFIR, p. 56 (no. 5), 19 December 2014.

²⁰⁰ Article 9 (10) of Commission Delegated Directive (EU) 2017/593 of 7 April 2016.

²⁰¹ Article 9 (11) of Commission Delegated Directive (EU) 2017/593 of 7 April 2016.

- ◆ the scheme of costs and charges is fair with respect to the features of the client;
- ◆ the charges don't affect negatively the expected return of the instrument;
- ◆ the structure of charges is easily understandable by the clients.

The process of target market's identification must be carried out in a granular level; more precisely, potential investors are divided in disparate classes of target market and each of them represent a different combination of knowledge, experience, financial situation, risk tolerance and investment objectives that will be accurately explained in the next paragraph. In this phase, that is considered the most important in the product governance process, the investment firm should also identify other classes of client for whose needs, features and objective are not compatible with the product taken into consideration²⁰². In this relevant step, the roles covered by manufacturer and distributor are important; although the strict cooperation, they present different approaches in the identification of target market.

First of all, the *manufacturer*, in order to identify the potential target market²⁰³, should conduct both quantitative and qualitative analysis.

ESMA through a Guideline²⁰⁴ has provided a series of categories that should be used by manufacturer as a starting point to establish the target market for its products. The manufacturer should use each category to assess the matching degree between the product and each class. The Regulator requires to manufacturer to not exclude any category during the assessment and, in the case of the manufacturer considers not enough exhaustive the number of classes for the analysis, it can propose and add supplementary categories. This modification of the pre-identified categories with respect to the classical guideline can lead to a complication in the communication and cooperation between manufacturer and distributor. Hence, the inclusion of additional categories is recommended only in specific and limited cases wherever additional classes are fundamental to identify a significative target market.

It is important to bear in mind that manufacturers can identify only potential target market because they don't generally have a direct contact with end clients. In fact, a manufacturing firm that produce internally financial instruments, but distributes them through an external investment firm, shall determine and analyse the features of the potential target market only

²⁰² See Article 9 (9) of Commission Delegated Directive (EU) 2017/593 of 7 April 2016.

²⁰³ Mocci F., Facchini J., "*Product governance: le Linee guida ESMA di definizione del target market*", in *Rivista di Diritto Bancario*, Luglio 2017.

²⁰⁴ ESMA Guidelines on MiFID II product governance requirements of 5 February 2018.

basing the assessment on their theoretical knowledge and experiences with similar instruments and investors²⁰⁵.

The manufacturer initially has to take into consideration five categories defined by ESMA and assess in a deeper manner the features of both the classes and products in order to identify a possible perfect match²⁰⁶:

a. The type of client to whom the financial product is targeted:

the first client screening is made on the classical client classification defined by MiFID II provisions. The manufacturer has to identify if a financial product is compatible with the features, objectives and needs of eligible, professional or retail clients. In other words, the manufacturer should indicate to which type of category the product is targeted.

b. Knowledge and experience:

the manufacturer should indicate the knowledge and experience that the potential client should have in order to be considered a potential client for a specific financial product. The knowledge that the potential client should have, is intended about the product's features, knowledge and experience of areas and variables that can affect the instrument. Knowledge and experience can be dependent on each other; in fact, an investor could be a potential target client even if he lacks the right experience but instead have a deep knowledge that can compensate the poor experience.

c. Financial situation with particular attention on the ability to bear losses:

in this section, the manufacturer has to explain in detail the quantity of losses that the client should be able to bear; it shall indicate the percentage of losses and if there are additional payment obligations that may exceed the amount invested.

d. Risk tolerance and compatibility of the risk/reward profile of the financial product with the target market:

Manufacturer should specify the degree of risk tolerance that the potential client should have in relation to the risk profile of the financial product. Then it should

²⁰⁵ See Article 9, Chapter III of Commission Delegated Directive (EU) 2017/593 of 7 April 2016.

²⁰⁶ "EU MiFID II product governance rules: Practical considerations for Asia-based DCM practitioners in the eurobond market", in Linklaters, December 2017.

classify the level of risk-attitude and provides a detailed description of each risk category.

It should be noted that, in the whole process, there are generally more than one firm and each of them can adopt a different approach to define the risk associated to a specific instrument. In this way the investment firm should publish the criteria under which a potential client is assigned to a specific risk category. The firm should use the risk indicators provided by the PRIIPs Regulation²⁰⁷ or by UCITS Directive²⁰⁸ if it is possible.

e. Clients' objectives and needs:

The investment firm should indicate the needs and client's objectives for which a specific instrument is designed and created. For example, an important factor in this analysis regards the holding period and the time horizon of the investment. Objectives and needs that a financial product should satisfy can be considered in a specific or wide range.

This represents the first screening phase carried out by manufacturer in order to identify a potential target market. This procedure is based on the analysis of the aforementioned categories.

However, the identification of the target market by manufacturer doesn't end with the abovementioned assessment based on categories, in fact the investment firm has to define the target market also basing the attention on the nature of the product. So, following this procedure, the choice of the potential target market should be conducted through an appropriate and proportionate analysis in relation to the features of the product; the relevant characteristics regard the complexity of the product, including costs and charges, the risk reward profile and liquidity or its degree of innovation. It is important to remark that, more complex a product is, more precisely the identification of the target market will be carried out; conversely, the simpler a product is, the less detailed a category may be. As I have reported before, the granularity level in the market identification represents a fundamental requirement in order to reduce, at minimum values, the possibility that a product is sold to a

²⁰⁷ Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs).

²⁰⁸ Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).

group of investors whose needs, characteristics and objectives are not compatible with those of the product considered.

There is a marginal case in which the investor could want a tailor-made financial product; in this extreme case the target market of this product will be composed by the single client who has ordered the product.

The *distributor* does not need an approval process, but it is responsible for assessing if the product meets the client's needs and if it is sold in the best interest of client; for these reasons it must carry out a more precise analysis of the target market.

Now the attention is focused on the identification of the target market by distributors²⁰⁹. The identification of the target market by manufacturer, as I have explained before, represents a sort of "potential" target market because the manufacturer, not having a direct contact with end clients, could identify only a potential target market. Conversely, the distributor has to define a more precise target market, the "actual" target market; this type of target market will be typically a narrower and a more specifically defined subset of the potential target market previously identified by manufacturer.

The analysis, in this case, is based on the information received by manufacturer and information received directly by end clients. This information, that includes the proper features of the client, the nature of the product and the type of investment service provided, could be obtained by the questionnaire or other several sources.

The categories from which they can identify the target market should be the same used by manufacturer; the distributor should usually accept the one chosen by manufacturer, so, in this way, it becomes a sort of tidying up process and not a proper selection of a specific target market. Then, analysing the information received from the manufacturer and the information obtained by desk research, it should identify its own target market. The resulting target market will represent the actual group of persons to whom the distributor will offer its products and services. Even in the case just considered, the distributor shall obtain the maximum quantity of information about actual client and potential client; from potential client for example, it can obtain information from other services that it has already been provided to that precise investor.

The distributor is entitled to offer services and products to investors and it should define, in a previous moment, a range on offer of these products and services; in the case of it isn't able to evaluate precisely the target market in relation to a particular service or product, for

²⁰⁹ ESMA Guidelines on MiFID II product governance requirements, 5 February 2018.

example the execution only service²¹⁰ for high-complex products or risks, it should be follow all the information received by manufacturer. Hence, in particular cases, the distributor could assume a prudential approach, deciding to not include in its product assortment a precise instrument; otherwise it can communicate to the client that it is not able to assess the matching level between the product and the risk profile of the client, but allowing it, in any case, to operate on behalf of client without the implementation of the advice service.

As the manufacturer defines the target market considering the nature of the product, even the distributor should choose the target market in a proportionate and adequate manner in relation to the product. The assessment of the target market by distributor has two sides of interpretation: on one hand the ex-ante evaluation can be affected by the services provided by the firm because the depth of the assessment of target market depends on the available information that in turn depends on the type of service offered by the firm (in fact is important to keep in mind that different services requires different streams of information; for example investment advice and portfolio management requires a higher level of information than other services); on the other hand the assessment of the target market affects the decision about what type of service will be offered in relation to the product's nature and features of clients.

However, the investor protection decreases if the distributor is not able to make a deep assessment of the target market; in this case, the operation can proceed but the distributor should communicate to investor that it is not able to evaluate the perfect compatibility between instrument and client's needs. Conversely, if the distributor wants to offer a portfolio management service must carried out in any case a deeper analysis of the target market²¹¹.

In any case, it is important to bear in mind that product governance rules don't substitute the assessment of suitability and appropriateness that should be carry out subsequently by the firm in the provision of investment services to each client²¹².

The EFAMA association²¹³ endorsed a standard template useful for manufacturer in order to deliver to distributor all the information about target market, costs and charges. The use of this template, known as European MiFID Template (EMT) is not compulsory, but a large

²¹⁰ Avena G., “*Execution only: l’intermediario è tenuto al rispetto degli obblighi di informazione e di adeguatezza anche nei confronti dell’investitore dichiaratosi esperto*”, in Banca e Finanza – servizi di investimento, 19 Dicembre 2016.

²¹¹ For a detailed example see the document “Product governance – Processo di definizione del target market effettivo”, in Credito Cooperativo, Cassa rurale ed artigiana di Cortina d’Ampezzo e delle dolomiti.

²¹² Par. 33 of ESMA Guidelines on MiFID II product governance requirements, 5 February 2018.

²¹³ European Fund and Asset Management Association is the representative association for the European investment management industry (EFAMA).

number of investment firms have already used this tool to provide data. In the tabs below, I'll illustrate only some section of the European MiFID Template. Commonly, in the EMT are reported the general financial instrument information, the features of the investor type, the knowledge and/or experience of the potential investor, the ability to bear losses, the risk tolerance, the client objectives and needs, the distribution strategy and all the possible costs and charges ex ante and ex post.

General financial instrument information

Num.	Campo dati		Definizione	Codifica
1	00010 Financial Instrument Identifying Data	M	Identificazione dello strumento finanziario	Presenta una delle seguenti voci in ordine di priorità: – codice ISIN ISO 6166 se disponibile – Altri codici riconosciuti (e.g.: CUSIP, Bloomberg Ticker, Reuters RIC) – Codice assegnato dal sottoscrittore, qualora le precedenti opzioni non siano disponibili. Il codice deve essere univoco e invariato nel tempo.
2	00020 Type Of Identification Code For The Financial Instrument	M	Codice identificativo selezionato per lo strumento finanziario	Presenta una delle seguenti opzioni: 1. ISO 66 per codice ISIN 2. CUSIP 3. SEDO 4. WKN 5. Bloomberg Ticker 6. BBGID 7. Reuters RIC 8. FIGI (codice identificativo globale dello strumento finanziario) 9. Altro codice proposto da ANNA 10. Codice assegnato dal sottoscrittore
3	00030 Financial Instrument Name	M	Nome dello strumento finanziario	Campo alfanumerico (massimo 255 caratteri)
4	00040 Financial Instrument Currency	M	Valuta di denominazione dello strumento finanziario	Codice ISO 4217
5	00050 Reporting Date	M	Data di inserimento del campo dati	AAAA-MM-GG ISO 8601
6	00060 Financial Instrument Legal Structure	M	Forma legale dello strumento finanziario	Prodotto Strutturato (S), Fondo Strutturato (SP), Fondo UCITS (U), Fondo non-UCITS (N)
7	00070 Financial Instrument Issuer Name	M	Nome dell'emittente dello strumento finanziario ovvero il soggetto responsabile dell'emissione e gestione dello strumento finanziario	Campo alfanumerico
8	00080 Financial Instrument Guarantor Name	O	Nome del soggetto garante dello strumento finanziario	Campo alfanumerico
9	00090 Product Category or Nature	O	Specificazione della tipologia a cui appartiene lo strumento finanziario o della natura dello stesso	Campo alfanumerico o codice
10	00100 Leveraged Financial Instrument or Contingent Liability Instrument	O	Strumento finanziario a leva o contingent liability	Y / N

Source: ACEPI

This is an example of the information about financial instruments reported in the section concerning the general information of financial products. The analysis of these parameters is useful to comprehend in detail the instrument taken into consideration. Through the identification with the capital letter M and O is stated which information among these are compulsory or optional.

Target markets – Investor Type

Num.	11	12	13
Campo dati	01010 Investor Type Retail	01020 Investor Type Professional	01030 Investor Type Eligible Counterparty M
Definizione	M	M	M
Codifica	Investitore retail	Investitore professionale	Controparte qualificata
	Y / N / Neutral	Y / N / Neutral / P (professionale di diritto) E (professionale su richiesta) B (entrambi)	Y / N / Neutral
Strumenti a leva			
Turbo	Y	Y	Y
Covered Warrant	Y	Y	Y
Leva Fissa	Y	Y	Y
Mini Futures	Y	Y	Y
Prodotti a capitale non protetto			
Benchmark (indici standard)	Y	Y	Y
Prodotti a capitale protetto	Y	Y	Y
Prodotti a capitale parzialmente protetto (Livello di protezione > 65%)	Y	Y	Y
Prodotti a capitale condizionatamente protetto	Y	Y	Y

Source: ACEPI

This is the template for the section regarding the information about investors; there are the three-classical type of investors: retail, professional and eligible. On the left-hand side is indicated the type of financial instruments and in the right-hand side, through the acronym Y, N and Neutral is indicated, for each of the instruments provided, if it is possible a perfect match between the features of the instrument and the needs, characteristics and objectives of the client.

In the example examined, there are five groups of instruments: leverage instruments²¹⁴, financial product not capital protected²¹⁵, financial product with capital protection²¹⁶,

²¹⁴ Leverage Instruments are financial products that generally offer high reward but also a high risk. If an investor buys this product, he obtains the right to buy or sell an underlying asset at a pre-fixed price and date.

²¹⁵ Financial product not capital protected allow the holder to invest in a specific underlying that will affect the performance of the instrument. The underlying are generally indexes, commodities or other underlying that are difficult to reach through a direct investment by an individual client. The most common are the Benchmark Certificates, Discount Certificates and Outperformance Certificates.

²¹⁶ Financial product with capital protection is an instrument that allow the investor to bet on rise or fall of the underlying but protecting the capital invested. The most common are Equity Protection Certificates and Butterfly Certificates.

financial products in capital partially protected²¹⁷, financial products to conditionally capital protected²¹⁸.

For each of these instruments, is indicated with Y, that states for yes and, N that states for Not, if they are suitable and if they meet the needs, characteristics and objectives of the category of investors considered.

Target Market – Ability to Bear Losses

Num.	18	19	20	21	22
Campo dati	03010 No Capital Loss	03020 Limited Capital Loss	03030 Limited Capital Loss Level	03040 No Capital Guarantee	03050 Loss Beyond Capital
Definizione	M	M	O	M	M
Codifica	Y / N / Neutral	Y / N / Neutral	Campo numerico decimale	Y / N / Neutral	Y / N / Neutral
Strumenti a leva					
Turbo	N	N	-	Y	Y
Covered Warrant	N	N	-	Y	Y
Leva Fissa	N	N	-	Y	Y
Mini Futures	N	N	-	Y	Y
Prodotti a capitale non protetto					
Benchmark (indici standard)	Neutral	Neutral	-	Y	Y
Prodotti a capitale protetto	Y	Y	-	Y	Y
Prodotti a capitale parzialmente protetto (Livello di protezione > 65%)	Neutral	Y	-	Y	Y
Prodotti a capitale condizionatamente protetto	Neutral	Neutral	-	Y	Y

Source: ACEPI

The tab “ability to bear losses” represents the capacity to bear losses of a specific target market. In relation to the features previous explained about financial instruments, we are able to assess the matching degree between the capacity to bear losses and the features of each financial instrument. It is clear, but important to remark, that for example a financial instrument that presents a high risk-level and so can lead to heavy losses is not suitable for

²¹⁷ The financial product in capital partially protected have the same features of financial instrument with capital protection with the exception that the capital is protected only partially, for example 90%, 80% or lower level.

²¹⁸ Financial instrument to conditionally capital protected is a financial instrument that allow you to bet on the rise of the underlying asset but at the same time protect the invested capital (in the case only the underlying does not touch the protection barrier); in rare case some type of certificates allow to earn even in the event of fall; the most common instruments of this type are Airbag Certificates, Cash Collect Certificates, Express Certificate and Twin Win certificates.

a target market identified with a low or null possibility to lose the capital invested. The product governance obligations are applied mainly in respect of the concept of end client. In some circumstances, an investment firm can sell a product to professional or eligible counterparty that act as intermediary; in this specific case the investment firm is not obliged to identify the target market. The investment firm has only the burden to identify the target market of end client. In the circumstance already mentioned, the professional or eligible counterparties could act as distributor, if they resell the product to end clients, or even as manufacturer if they modify the product. It's obvious that in the two last cases, the professional or eligible counterparty, acting as manufacturer or distributor, should respect the product governance obligations.

The target market, in some cases, could be composed by professional or eligible counterparties. In this case, with respect to the former category, the investment firm has to distinguish if they are "per se" professional client or professional client "on request" because this indicates a different degree of knowledge (in fact, it is assumed that the two types of professional clients have a different degree of knowledge). In the latter case, if the end client class is composed by eligible counterparties, although the product governance obligations are compulsory, the assessment of knowledge can be carried out in a less deep manner.

❖ **Distribution of financial instrument to the target market**

As I have explained before, the first step in the product governance process regards the identification of a potential target market and an actual target market respectively by the manufacturer and distributor; they must identify the target market in order to create a perfect match between the features of financial instruments and the needs, characteristics and objectives of the target market. A very similar approach is carried out when the investment firm has to choose the correct distribution strategy. Even in this step, manufacturer and distributor shall identify a distribution strategy in accordance with the needs, characteristics and objectives of the target market.

In this phase, the first step is carried out again by the *manufacturer*; it is responsible for recommending a distribution strategy coherent with the target market and that it can deliver the financial instrument to the right target market²¹⁹. Other than the identification of the distribution strategy, the manufacturer has to select the right distributor in order to guarantee that services and clients of that distributor are compatible with the target market. Therefore, the manufacturer should provide an adequate stream of information in order to ensure that

²¹⁹ Art. 24 (2), Section II of Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014.

the distributor can assess precisely the target market²²⁰ ; then it should recommend which services are more appropriate to provide these financial instruments.

Once the distribution strategy has been defined by manufacturer, the burden of the choice falls again in the hands of the *distributor*²²¹.

First of all, the distributor should consider the strategy recommended by the manufacturer and then assess if the strategy is correct, otherwise it can decide to adopt a more prudential approach, granting a higher level of investor protection, or a less prudential approach. The final approach will be identified considering all the relevant features of the product and client together.

In the case of the distributor will decide to adopt a less prudential approach, after an accurate analysis, it should report to the manufacturer the information about the choice. The Regulator has allowed some deviations from the target market in precise circumstances. The distributor has the right to deviate from the target market; it means the possibility to sell the product to a client that is not included in the target market. The group of clients not belonging to either the positive and negative market of a financial product are located in a sector known as “Grey zone”²²². This is possible if the product respects particular needs and objectives of the client and in the case of the financial instrument respects the suitability and appropriateness rules for that precise investor too; the most common reason that involves the deviation from target market are diversification and hedging²²³ purposes. For the sake of simplicity, we can think about the sale of an interest rate swap²²⁴ (IRS)²²⁵ out of the target market; this type of financial instrument can be used for hedging purpose²²⁶ by a client subject to interest rate risk depending on other financial activities in the portfolio. These issues were very complicated to solve but ESMA, after some consultations, modified the guidelines in order to reach a common solution. Hence, as the consequence of the modification of guidelines, every distributor can deviate from the target market justifying in a detailed manner every choice; this does not automatically address to the distributor the burden to communicate (reporting rules) to manufacturer if it has deviated from the target market for hedging or

²²⁰ Section V of ESMA Guidelines on MiFID II product governance requirements, 5 February 2018.

²²¹ Naccarato M. G., “*La nuova governance del prodotto e le regole in fase distributiva*” in Rivista di Diritto Bancario, Novembre 2016.

²²² Par. 52 of ESMA Guidelines on MiFID II product governance requirements, 5 February 2018.

²²³ Hedging strategy is a technique useful to reduce the exposure to various risk.

²²⁴ An Interest Rate Swap (IRS) is an interest rate derivative; it consists in an exchange of interest rate between two parties. An Interest Rate Derivative is a derivative instrument whose payments are computed through calculation techniques where the underlying benchmark product is an interest rate, or set of different interest rates.

²²⁵ For a deeper analysis see Hull J. C., “Mechanics of interest rate swap”, in Options, Futures and other Derivatives, Pearson, pp. 149-154, 2012.

²²⁶ For a deeper analysis see Hull J. C., “Options, Futures and other Derivatives”, Pearson, 2012.

diversification purposes. In this sense, the distributor is not obliged to communicate to manufacturer if it sells out of the target market a specific financial product for the aforementioned purposes after an assessment of suitability between the financial instrument and the portfolio.

Conversely, if the sale of the product occurs in the negative target market for the same previous goals, the communication to the manufacturer is compulsory. ESMA guidelines, however, recommend the distribution of products in the negative target market only in exceptional circumstances²²⁷. All the specifications of negative target market will be explained in the following section.

In the stage of distribution will be established if the product will be effectively sold to the target market identified by the manufacturer at the origin; otherwise the target market will change with respect to those identified in the early stage.

For these reason, manufacturer and distributor should assess for what target market the product is not compatible; in order to identify this type of clients they should carry out the same strategies applied for the identification of the positive target market²²⁸. Even in the context of the negative target market, the analysis will present two different output: on the side of the manufacturer, considering the fact that it is able to asses only a theoretical analysis, will be identified only a potential negative target market; the distributor, for the same reason explained in the previous paragraphs, will be able to identify a concrete negative target market.

If we consider, for example, a specific product that presents a speculative aspect, we can automatically assert that this product is not able to meet the objectives and needs of a client that wishes to hedge and protect the portfolio with low-risk products. In this case the negative target market is simply defined considering all the other potential investors that are not appropriate to this specific product with respect to their needs and investment objectives; in other words, it is incompatible for all the investors out of the positive target market.

In order to conduct a deep and precise analysis, the assessment should be carried out in different manner in relation to the complexity or riskiness of the product. As a consequence of this, exist very different target markets in relation to the width of the market.

In fact, if we consider a very simple product like a plain vanilla instrument²²⁹, we will find a restrict negative target market; this is verified because the product is compatible for a wide

²²⁷ Par. 52, 53, 54, 55 of ESMA Guidelines on MiFID II product governance requirements, 5 February 2018

²²⁸ Par. 67 of ESMA Guidelines on MiFID II product governance requirements, 5 February 2018.

²²⁹ Plain vanilla states for the most basic or standard version of a financial instrument; generally, with this adjective are indicated some type of options, bonds, futures and swap.

range of investors due to its simple structure²³⁰. Conversely, the negative target market of a complex financial product is probably wider than the negative target market of a plain vanilla instrument; this results from the specific features of complex products which are compatible for a restrict class of clients.

Once identified the negative target market, the investment firm has evaluated that a financial product is not consistent with the needs of a specific client class; for this reason a firm, only in very rare cases, should sold the product to this client class. In the extreme case in which is verified a sale in the negative target market, it must be justified carefully, and analysed in a precise manner in all the steps before the selling phase; the whole process must be justified and analyse in a deeper way than in the case of the sale out of a positive target market.

As I have explained previously, the sale of financial products out of the target market should occur in limited circumstances; but in the event that this phenomenon is verified in a significance amount, it must be reported in an adequate manner for the analysis of the products and services provided²³¹. In the final part of the analysis, the distributor should interpret and evaluate the information received and it should implement a plan of action in order to modify the initial target market or the distribution strategy towards more appropriate categories of clients.

So, in this way, the events regarding the delivery of products and services in a relevant amount out of the positive target market has to be communicated to the distributor except in the cases of portfolio diversification and hedging purpose; conversely, the sale of products in the negative target market should always be reported to the manufacturer and communicate to the client even if the final purpose are diversification or hedging.

❖ **Regular review of financial products**

In this part of the process, manufacturer and distributor have to regularly review the financial instruments involved²³².

The *manufacturer* has to assess and revise the financial product considering any occurrence that could affect the potential risk to the identified market; it should control if the financial product remains consistent with the characteristics, needs and objectives of the target market and if it is actually distributed to the right clients or if, conversely, the instrument has reached a class of end clients whose needs, characteristics and objectives are not conformed with that specific instrument.

²³⁰ Par. 69 of ESMA Guidelines on MiFID II product governance requirements, 5 February 2018.

²³¹ See Article 10 (2) of Commission Delegated Directive (EU) 2017/593 of 7 April 2016.

²³² Art. 16 (3) of Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014.

In general, the manufacturer must review products before it will launch or resell them if it knows that there are some events that could affect the potential risk to investor. In addition, it should make a periodical evaluation to verify if the product again functions in accordance with the intended objectives. The time frame for the periodical revision is established by the firm; it is based on the complexity and the relevant factors of each product.

Then the manufacturer should identify, in a preventing manner, all the events that could affect potential risks to investor and the expected return of the instrument; the most relevant are:

- if some parameters cross a threshold that indicate changing in the expected return of the product,
- the solvency of certain issuers whose securities may affect the performance of financial instrument²³³.

If such events happen, the new regime requires that the manufacturer implement a plan to stem the impact of the negative event or solve the problem in a proportionate and appropriate manner. The Regulator, through the launch of Delegated Directive (EU) 2017/593 of 7 April 2016, has provided a series of measures and actions that investment firms should follow in these negative occurrences:

- the investment firm should communicate to the client (or to the distributor if we are considering a manufacturer firm) the information about a specific event and the consequences that this event could have in the financial instrument's performance;
- in some cases, the investment firm should change the product approval process;
- it should change the financial product to avoid the resell of unfair contract;
- it could stop the intended following issuance of that specific instrument;
- the investment firm must revise and assess the distribution strategy; it could sometimes happen that the chosen distribution strategy, and the consequent distribution channels, are not appropriate for a precise financial product. For example, it could happen that a financial product that was created for an elite group of clients, it has been sold later to a large group of investors. In this case it is necessary a cooperation with the distributor in order to identify a more appropriate distribution process.

²³³ Art. 9 (15) of Commission Delegated Directive (EU) 2017/593 of 7 April 2016.

- In an extreme case, it could be necessary to end the relationship with the distributor and hence evaluate other possible candidates that can cover the role of distributor;
- it can be useful to communicate the problems to the competent authorities²³⁴; this event is strictly linked with the product intervention regime. The direct relationship between product governance and product intervention will be analysed later.

In order to comply with these obligations is necessary a strict relationship and cooperation between distributor and manufacturer. In fact, the manufacturer should receive periodically the right stream of information from the distributor²³⁵.

The Regulator, after a series of proposals, critiques and resistances from some financial players, has established that the reporting duties, more precisely all the information necessary for a correct assessment of the consistency of a product in relation to the needs, characteristics and objectives of the clients, is a fundamental pillar for the correct functioning of product governance obligations.

The relevant information in this context regards the data about clients, the sales out of the target market and the objections from clients²³⁶.

In the context of monitoring obligations, also the *distributor* is subject to these obligations and has a certain responsibility. It is obliged to review periodically the product governance rules in order to assure that they continue to meet the initial purposes; if there are some deviations from the original aims, it must take in place actions and measures for the purpose of achieving again the objectives²³⁷.

In addition to this, the distributor must carry out a periodical assessment of the products offered or recommended and checks if they remain consistent in relation to the needs, characteristics and objectives of the clients, as well as the appropriateness of the distribution strategy.

In the case of the distributor ascertains that it has wrongly identified the target market for a precise product or that the product considered no longer meets the needs and objectives of the target market it must update or modify the product governance arrangements²³⁸.

Hence, manufacturer and distributor have to be revised periodically products and services provided for the purpose of assessing the compatibility with the identified target market.

²³⁴ For a detailed analysis of National Competent Authorities see ESMA List of competent authorities to carry out the duties provided for by the Directive 2014/65/EU on Markets in Financial Instruments (MiFID II) as required by Article 67 (3) of MiFID II of 3 January 2018.

²³⁵ Art. 10 (9) of Commission Delegated Directive (EU) 2017/593 of 7 April 2016.

²³⁶ Recital 20 of Commission Delegated Directive (EU) 2017/593 of 7 April 2016.

²³⁷ Art. 10 (4) of Commission Delegated Directive (EU) 2017/593 of 7 April 2016.

²³⁸ Art. 10 (5) of Commission Delegated Directive (EU) 2017/593 of 7 April 2016.

This monitoring procedure requires a perfect cooperation between manufacturer and distributor because, on one hand the manufacturer has to consider the amount of information needed and how to get it, on the other side, the distributor, to support the task of the manufacturer, should provide all the relevant data linked with the product.

The relationship between manufacturer and distributor has been tightened and now require a more accurate supervision and cooperation; this is fundamental for an efficient exchange of information and a higher degree of transparency that allow, at the end of the cycle, an improvement of the investor protection²³⁹.

❖ **The responsibility of management body for product governance arrangements**

The product governance regime and the correlated processes have to be controlled regularly; the management body is responsible for this type of assessment. The product governance, which is as important as it is complex, requires to the compliance function an accurate monitoring of the development of the arrangements; this is useful to avoid any risk of failure by the investment firm to comply with the obligations²⁴⁰.

Accordingly, a compliance report has to be delivered to the firm's management body²⁴¹ periodically and must always include the trend and the data about the products manufactured and/or offered by the MiFID firm²⁴². Furthermore, the investment firms have to present the report to their competent authorities on request.

So, in this context, it addressed to the compliance function²⁴³ a central role in the supervision of the internal rule that discipline the product governance process. Hence, the management body is entitled to define, approve and supervise the policy of the investment firm in relation to products, operations and activities in accordance with the risk tolerance of the firm and the needs and characteristics of the end clients to whom the products are offered. The rules concerning product governance are extended to all players involved in the path that regards a financial instrument.

Therefore, all the staff involved in the process of the creation of the product has to possess the right skills and competencies²⁴⁴ to comprehend the features and risks of products that are intended to be manufactured.

²³⁹ Newnham M., *"The state of play of MiFID II on fund distribution"*, in Journal of Securities Operations & Custody, Volume 10, Number 2, pp. 117-124(8), 1 March 2018.

²⁴⁰ Art. 9 (7) of Commission Delegated Directive (EU) 2017/593 of 7 April 2016.

²⁴¹ Art. 9 of Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014

²⁴² Art. 9 (6) of Commission Delegated Directive (EU) 2017/593 of 7 April 2016.

²⁴³ Final Report – ESMA's Technical Advice to the Commission on MiFID II and MiFIR, 19 December 2014.

²⁴⁴ Final Report – ESMA's Technical Advice to the Commission on MiFID II and MiFIR, p. 56 (no. 6), 19 December 2014.

Always in the context of responsibility, not directly linked with the management body, but however worthy of note, is the final responsibility in a chain of investment firms. ESMA Technical Advice states that when different firms work together in the distribution phase, the last firm in the chain, namely the firm that has a direct contact with the client has the duty to guarantee the application of product governance obligations. The intermediate distributor in turn has the duty to facilitate the exchange information between the manufacturer and the final distributor even if, in any case, it must respect the product governance obligations²⁴⁵.

Timing and Grandfathering

The product governance regime, like the major provisions of MiFID II, has entered into force from 3 January 2018.

There are no direct grandfathering provisions under the new legislative package.

However, ESMA has communicated that manufacturer and distributor, and so the financial instruments produced and distributed before the entry date, 3 January 2018, are not subject to product governance rules²⁴⁶.

Conversely, the products that are manufactured before that entry date, but which are distributed to investors after 3 January 2018, would fall under the product governance regime for distributors, in particular under the obligation concerning the identification of the target market. In this precise situation, the distributor should apply the provisions regarding the relationship between a MiFID distributor firm with a non-MiFID manufacturer firm, namely in a deeper and accurate manner. In the case where the manufacturer has already provided a potential target market, the distributor, after a precise review, could decide to maintain the target of client identified by the manufacturer²⁴⁷.

Product Governance Obligations for Investment Firm Operating in Wholesale Market

The obligations set out in the Art. 16 (3) and in Art. 24 (2) are referred to all the possible clients, i.e eligible, professional and retail. At the same time these provisions are addressed to end clients. So, if we consider a chain of firms involved in the production process of financial instruments, should be presented a model formed by a series of connections between many

²⁴⁵ See p. 61, Technical Advice n. 31 of Final Report – ESMA’s Technical Advice to the Commission on MiFID II and MiFIR, 19 December 2014.

²⁴⁶ Par. 64 of ESMA Guidelines on MiFID II product governance requirements, 5 February 2018.

²⁴⁷ Par. 65 of ESMA Guidelines on MiFID II product governance requirements, 5 February 2018.

investment firms before the stage in which is implemented the relationship with the end client. In this context, an investment firm, that represents a unit of the entire chain, is not obliged to indicate the reference of target market within the intermediary chain, that means it is not subject to the burden to indicate the target market for other firms within the intermediary chain²⁴⁸. Conversely, it must identify the target market of end clients, namely the final client in the chain. In fact, the investment firm that covers a role of manufacturer or distributor cannot be considered as a final client. However, for this reason, if the firm in the chain acts as manufacturer (remodelling and modifying the products) or as distributor (delivering the product to the end client), it should respect the product governance rules respectively for manufacturer and distributor.

In the context in which there are only professional and eligible counterparties, we can talk about the wholesale market. This environment assumes a certain degree of knowledge and experience that in turn affect the capacity for comprehension of risks.

Taking into consideration a professional end client, the firm can assume that this type of client is able to understand the risks connected to the financial instrument; furthermore, within this category it is necessary to make a distinction in two subsets, namely “per se” professional client and professional client “on request”²⁴⁹. In this latter distinction, the investment firm must consider that the professional client on request generally has a lower degree of knowledge than the per se professional client.

With regard to the eligible counterparty, although it covers the highest tier in the hierarchical pyramid of knowledge and, at the same time the lowest tier in term of protection, the MiFID II regime attempts to improve the level of protection also for this category.

Nevertheless, a firm, in a trade relationship with an eligible counterparty as end client, is not obliged to respect the provisions in Art. 24 of MiFID II except for the points 4²⁵⁰ and 5²⁵¹; it must anyway conduct the operation in a correct, clear and not misleading manner and following the provisions in Art.16²⁵².

Even in this context, MiFID II attempts to improve the investor protection as a whole, notwithstanding, having more attention for the retail client²⁵³, which is historically been considered the weakest financial player.

²⁴⁸ Par. 75 of ESMA Guidelines on MiFID II product governance requirements, 5 February 2018.

²⁴⁹ Par. 81 of ESMA Guidelines on MiFID II product governance requirements, 5 February 2018.

²⁵⁰ Appropriate information shall be provided to the client in a good time, for a deep analysis see Art. 24, Par. 4 of Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014

²⁵¹ Information should be provided in a comprehensible manner, for a deep analysis see Art. 24, Par. 5 of Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014

²⁵² Art. 16 (3) of Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014

²⁵³ Moloney N., “*The investor model underlying the EU’s investor protection regime: consumer or investors?*”, in European Business Organization Law Review, Vol. 13, Issue 2, pp. 169-193, 28 June 2012.

3.3 Complex and Structured Products

The investment firm, in the selling practice concerning complex²⁵⁴ and structured products, has to be in compliance with more stringent obligations. In general, these types of products require a high degree of attention²⁵⁵ due to the complex structure and the correlated difficulty in the comprehension of risks and expected rewards.

ESMA, through an Opinion, highlights the need to adopt specific and stronger organisational provisions, as well as a more developed internal control in order to ensure the respect of the client's interest in the distribution phase.

The complexity of a product is often translated in a lack of information; in fact, if the intermediary claims that a complex product will rarely satisfy the needs of a client or that the product, due to its intrinsic features, is difficult to be assessed because of the opaqueness of the available information, it shouldn't be sold. NCAs have the task of monitoring the actions conducted by the intermediary²⁵⁶ for the purpose of avoiding miss-selling practices.

ESMA has provided a list of complex products which includes an explanation of all the features that can characterize a complex financial product²⁵⁷. Even CONSOB has defined a series of features and systematic elements that can affect financial products including them in the category of complex products; therefore, it also highlights an important consideration that it is often disregarded: the riskiness and the complexity of a product are not always linked with a directly proportional function; in fact, in the financial system have been created complex products with a low risky-level and vice versa. However, in general the complex products²⁵⁸ are normally characterized by difficult comprehensibility, opaqueness and high riskiness. ESMA and CONSOB have delineated some elements that are usually included in complex products:

- The presence of derivatives
- The presence of underlying instrument difficult to evaluate
- The use of opaque indices
- Problems of liquidity

²⁵⁴ Through the analysis of the Art. 25, Par 4 of Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014 it can be identified the group of financial instruments that can be considered as complex products.

²⁵⁵ Di Nella L., “*Features of the New Financial Markets Law (MIFID 2 AND MIFIR)*”, in *Revista Brasileira Direito Civil* 119, pp. 141-143, 2018.

²⁵⁶ Opinion on MiFID practices for firms selling complex products, ESMA 2014/146 of 7 February 2014.

²⁵⁷ Point 10 of Opinion on MiFID practices for firms selling complex products, ESMA 2014/146 of 7 February 2014.

²⁵⁸ Lener R., Lucantoni P., “*Regole di condotta nella negoziazione degli strumenti finanziari complessi: disclosure in merito agli elementi strutturali o sterilizzazione, sul piano funzionale, del rischio come elemento tipologico e/o normativo*”, In *Banca Borsa Titoli di Credito*. Fasc. 4, p.369, 2012.

- Exit barriers
- Payoff structure involving multiple variables and complex mathematical formulas.

Then CONSOB has provided a list, known as “Black list”, in order to indicate some complex financial products that the intermediary should not sell to retail client for the purpose maintaining a high level of protection²⁵⁹.

In any case, the intermediary is always obliged to carry out a deep due diligence in relation to the complex financial products included in its product catalogue²⁶⁰.

In particular, the structured retail products (SRP)²⁶¹ are difficult to understand by retail clients; they are not able to assess adequately the drivers of risks and returns of structured products. For these reasons mainly, the retail client can incur in heavy losses that in turn can lead to a decrease of confidence in regulatory framework or financial markets and can threaten the reputation of manufacturers and distributors.

ESMA has defined product governance rules with a huge importance and as a fundamental pillar for the investor protection. Hence, the soundness of this regime must be assured mainly in the context of complex products in order to limit the intervention of the competent authorities. In this framework the product governance must be followed in a very precise and deep manner and, both manufacturer and distributor of SRP should regularly assess each stage from the manufacturing and distribution to the post-selling monitoring phase.

Following the ESMA’s Opinion, the steps are very similar to those of the classical product governance regime; in fact, the main stages are²⁶²:

- general organisation arrangements in which are defined the steps before the manufacturing and distribution phases, the role and responsibility of internal players, the review regime and the flows of information necessary among distributor and manufacturer;
- product design in which are considered the needs, characteristics, interests and objectives of potential clients;
- product testing in which are assessed potential risks of the product and in which are tested the possible performances;

²⁵⁹ CONSOB Communication n. 0097996 of 22 December 2014.

²⁶⁰ Di Nella L., “*Le regole comportamentali nella distribuzione di prodotti finanziari complessi*”, in “La MiFID II, rapporti con la clientela, regole di governance, mercati”, pp. 113-165, a cura di Troiano V., Motroni R.

²⁶¹ Structured Retail Product (SRP) is a financial product composed by a base instrument such as a note fund or deposit with embedded derivatives that provides economic exposure to reference asset, portfolios or indexes.

²⁶² Opinion on Structured Retail Products – Goods practices for product governance arrangements, ESMA 2014/332 of 27 March 2014.

- the identification of target market concerns the identification and the analysis of possible end clients for each SRP; it's very similar to the aforementioned classical product governance regime;
- the distribution strategy in which are defined the methods to identify the right distributor/distribution strategy, the role and the responsibility of the different players. Even in this context, the flow of information between manufacturer and distributor is relevant in order to act in accordance with the product governance rules;
- assessment of the value at the date of issuance and transparency costs: through this process the manufacturer or distributor have to communicate the value of the instrument in accordance with the models and methodologies used in the product design and product testing phases;
- information about the secondary market: in this phase the investment firm should provide all the information to end client concerning the trading in secondary market;
- the review process is useful to assess the product governance arrangements for the purpose of ameliorating the previous stages and the performance of the SRP.

The sale of complex products represents, since the crisis period, an important source for investment firms but at the same time a dangerous threat for the investor; in particular, for the retail class of investors that doesn't have the right competencies to understand the relevant features of these type of financial instruments²⁶³. Hence, in this field, it is necessary an increasingly detailed and efficient model of regulation that can assist both clients and investment firms²⁶⁴.

²⁶³ Musile Tanzi P., *“Come cambia la governance dei prodotti finanziari complessi”*, in *Strumenti finanziari e Fiscalità*, 10 Luglio 2015.

²⁶⁴ Avgouleas E., *“Regulating financial innovation. A multifaceted challenge to financial stability, consumer protection, and growth”*, in *Oxford Handbook of Financial Regulation*, Oxford University Press, 2014.

3.4 The Interconnection between Product Governance and Product Intervention

The global financial crisis has highlighted many flaws in the old legislative framework and, among other things, one of the main hole is represented by the failure of the market directly linked with the role of the Regulator²⁶⁵.

Since 2010, the European Union has created a supervisory system called the European System of Financial Supervision (ESFS). The system is composed by the European Supervisory Authorities²⁶⁶ (ESAs), the European Systemic Risk Board (ESRB), the Joint Committee of the European Supervisory Authorities, and the national supervisory authorities of EU member states. They are responsible for the assessment of the correct functioning of the system and for the periodical monitoring function. In fact, as reported in MiFIR regulation, the competent authorities have to monitor financial products and structured deposits²⁶⁷ that are created, marketed, distributed and sold in their state or from their state²⁶⁸.

The old directive was not able to correct completely the problem of asymmetric information and mis-selling and the resulting negative impact on financial market due to the misleading selling of toxic and opaque products.

Initially, in this way, the new legislative package aims at improving the investor protection and confidence in the financial system; introducing the product governance rules, as a means to control and prevent cases of mis-selling, the Regulator has imposed a rigid framework in the phases of creation, designing, marketing, distribution and selling of financial products. The product intervention instead, considered by many scholars the natural legislative complement of product governance, was introduced in order to limit or denied the diffusion of dangerous product to the single investor and to guarantee the integrity of the whole financial system.

Hence, MiFID II and MiFIR, with the implementation of product intervention, has mandated the national and supranational authorities to control and intervene, both in a preventive manner and during the process, in the creation, marketing, distribution and selling of products of the Union.

²⁶⁵ Franza E., “La *“product intervention” del mondo MiFID II/MiFIR*”, in *Rivista di Diritto Bancario*, Dicembre 2017.

²⁶⁶ The European Supervisory Authorities (ESAs) is composed by The European Banking Authority (EBA) in London, The European Securities and Market Authority (ESMA) in Paris and The European Insurance and Occupational Pension Authority (EIOPA) in Frankfurt.

²⁶⁷ Lorenzi P., “La disciplina dei depositi strutturati: dalla MiFID 2 alla bozza di consultazione del Regolamento Intermediari”, in *Rivista di Diritto Bancario*, Ottobre 2017.

²⁶⁸ Art. 39, Ch. 1, Title VII of Regulation (EU) No. 600/2014 of the European Parliament and of the Council of 15 May 2014.

National authorities should intervene²⁶⁹, prohibiting or limiting²⁷⁰ some financial instruments, when they can affect negatively the investor protection, the correct functioning and the integrity of the financial market or commodity market or when a derivative instrument has a negative influence in the pricing procedure of the underlying market.

In this way, the Regulator, introducing an actual intervention power in favour of the authorities; it has wished to complete the product governance regime believing that the product intervention regime could make sure the effectiveness of the product governance rules.

It is possible to talk about the product intervention like a complementary tool of the product governance regime because the intervention powers in the hands of authorities should be used as a means of “last resort” in the extreme case in which all the other possible actions are not available or wouldn’t produce a successfully result. In particular, the intervention power should be activated only when there is an evident failure of the product governance regime.

However, the Regulator enables, in extreme cases, the intervention by the authorities, as a precautionary measure, before the marketing, distribution or sale of products to end client²⁷¹.

Obviously, in order to ensure a correct functioning of both process of product governance and product intervention, it must be implemented a perfect cooperation between the authorities.

MiFIR has imposed some rules in the monitoring practices that must affect and regulate the relationship between national and supranational authorities.

In brief, National Competent Authorities before the implementation of any actions must inform ESAs that in turn must communicate an opinion related with the proposal of NCA; however, the opinion of ESA is not binding but in the case of the NCA decide to operate anyway, it has to justify the choice accurately.

The action implemented by ESA predominate the action of NCA and maintain the effect for three months, after that the action can be renewed, otherwise it expires and loses any effect.

The powers of the national and supranational authorities can be summarized in:

- NCAs’ actions:
 1. are not subject to a periodic review;
 2. are not subject to final term;
 3. must be revoked only if the grounding facts no longer exist.

- ESAs’ actions:

²⁶⁹ Art. 40 (1) of Regulation (EU) No. 600/2014 of the European Parliament and of the Council of 15 May 2014.

²⁷⁰ Art. 9 (5) of Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority).

²⁷¹ Recital 29 of Regulation (EU) No. 600/2014 of the European Parliament and of the Council of 15 May 2014.

1. must be reviewed every three months;
2. are subject to final term;
3. have temporary effects.

For a deeper analysis of the criteria that must be taken into account when authorities want to implement measures and actions, the European Commission has issued a Delegated Regulation²⁷² containing some details about the criteria that must be followed in order to implement the intervention power.

In general, the intervention measures can be classified in four categories²⁷³:

- the possibility to ban the sale of certain product to retail investor;
- the possibility to ban specific features of some products;
- the possibility to ban the marketing of specific product to certain class of client;
- provide additional information for certain products

After the analysis of the new product governance rules and product intervention regime, it is possible to assert that these two sections of the MiFID II package must be analysed in conjunction.

The last financial crisis has highlighted the massive asymmetric information among market players. This automatically led to a remarkable lack of transparency in the market and a decreasing in the investor protection²⁷⁴. These legislative holes in turn has brought the investors, in particular the retail class, to invest in financial products that later showed high incompatibility in relation to the needs, characteristics and objectives of some types of clients²⁷⁵. The efforts implemented by the Regulator to revise the old legal framework, in order to solve the flaws that emerged during the financial crisis, were realised through the introduction of an ex-ante regime, namely product governance and an ex-post action, namely product intervention.

These regimes should avoid the selling of harmful and complex products to investors that are not able to manage them.

²⁷² Commission Delegated Regulation (EU) 2017/567 of 18 May 2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council with regard to definitions, transparency, portfolio compression and supervisory measures on product intervention and positions.

²⁷³ For a deeper analysis see SMSG Advice to ESMA, “Own initiative report on product intervention under MiFIR”, 16 June 2017.

²⁷⁴ Busch D., “*MiFID II and MiFIR: stricter rules for the EU financial markets*”, in *Law and Financial Markets Review Journal*, Vol. 11, Issue 2-3, pp. 126-142, 2017.

²⁷⁵ Carotenuto G., “*Product intervention under MiFID II/MiFIR*”, in *Rivista di Diritto Bancario*, Settembre 2017.

In this way, they could avoid many cases of mis-selling that were widespread in the period before the crisis; in fact, a lot of financial instruments were sold mainly respecting the own interest of the investment firms rather than the best interest of client.

3.5 How Product Governance Affects Investor Protection: The Mis-selling Problem

Traditionally, the main goal of the legal framework in the economic environment is the protection of the retail client against the flaws and imperfections of the market²⁷⁶, that generally represents the weakest and the lowest informed individual. The Regulator, with the implementation of product governance regime, has attempted, inter alia, to stem the damages and the hazards originating by the misleading behaviour of intermediaries. These market players, that cover a central role in the product governance, exploiting the gap in knowledge, experience and skills in relation to those of client, have often acted in their own interest rather than in the best interest of client.

This misleading behaviour has led to problems both in the relationship between intermediary and client (retail conduct failure) and in the correct functioning and integrity of the financial system (market conduct failure).

In many cases, the investor protection ruleset, mainly in the old legislative framework, was based on the suitability and appropriateness procedures but these measures have led to mis-selling practices anyway. Some limits of these measures have emerged recently because these tests are taken in place only at the end of the life-cycle of the product.

Regulator, due to these poor results, has decided to implement the product governance and product intervention regime with the aim to stem, among others, the risk of mis-selling.

EBA has reported in the joint position a series of the most relevant cases of mis-selling in Europe; for the sake of explanation, it will be presented a bullet list subdivided according to the classification among Member States²⁷⁷:

²⁷⁶ Paces A. M, Heremans D., “Regulation of banking and financial markets”, in *ENCYCLOPEDIA OF LAW AND ECONOMICS: REGULATION AND ECONOMICS*, 2nd Edition, a cura di A.M. Paces and R.J. Van den Bergh, eds., Elgar, 2012.

²⁷⁷ Joint Position of the European Supervisory Authorities on Manufacturers’ Product Oversight and Governance Processes, JC-2013-77.

- UK case²⁷⁸: in a period in which the traditional securities sector was instable and volatile, many investors has decided to purchase alternative products that, due to their intrinsic features, are not able to meet the needs of that investors and had a high probability to fail. Other than this, there was a huge amount of mis-selling of Payment Protection Insurance (PPI)²⁷⁹ products by some of the largest banks in UK²⁸⁰.
- Denmark case: in Denmark were sold very complex structured products to retail investors that didn't have the right competence and experiences to understand the product as well as a high degree of risk aversion; these clients' characteristics didn't allow a perfect match with those instruments.
- Belgium and Finland cases: the high complexity of some products prevented the possibility by investors to understand the features of products and in this way led to poor and wrong investment decision.
- Spain case: Spanish banks has sold to retail investors hybrid financial products; they didn't explain accurately all the information and risks regarding these types of instruments. Then, Spain presented problems related to the bad presentation of the risk of structured products; many complex products were sold to a client class that are not compatible with them. Estonia have experienced similar problems.
- Italy case: in Italy during the period of crisis were sold many complex products to retail investors.
- France and Netherland cases: in these states there was a problem in the selling practice of insurance products; they were characterized by high and opaque cost structure.
- Latvia case: in Latvia were sold PRIIPs that were not regulated by any legislative framework and obligations.

In order to stem these phenomenon that signed in a remarkable manner the investor protection and the investor confidence in the financial system, the Regulator has introduced an harmonize legislation for the purpose of recovering the investor confidence and solve the problems caused by the fragmentary supervision power in favour of common practices for all Member States.

In this way, as regards the banking and insurance sector, the focus of the attention is switched from an informative perspective to a perspective based on the intermediaries' obligations

²⁷⁸ Zepeda R., "*Derivatives mis-selling by British banks and the failed legacy of the FSA*", in *Journal of International Banking Law and Regulation*, 2013.

²⁷⁹ Payment Protection Insurance (PPI) is an insurance product that allow a consumer to ensure the repayment of credit against some borrower problems.

²⁸⁰ Connell P., Blacker K., "*Systemic operationl risk: the UK payment protection insurance scandal*", in *The Journal of Operational Risk*, Vol. 7, Number 1, pp. 79-139, Spring 2012.

(strictly linked with product governance) and supervision powers useful as efficient tools to recover the confidence of investor and improve the level of protection²⁸¹.

The relationship between intermediaries and clients is fundamental in the investment process; the presence of events in which intermediary adopt a misleading behaviour exploiting the phenomenon of asymmetric information it is a recurrent theme; for example, a common practice consist in to deceiving the investors about risks and costs of a specific financial instrument. Even if all the relevant information is disclosed, it often happens that due to the lack of skills and competencies of some client classes, the information is not understood in the correct manner²⁸².

3.6 Non-MiFID Firms and the Problem of Information-Gathering Process

The product governance rules, implemented through the introduction of the new legislative package, have affected all the investment firms located in the European Economic Area that for this reason are subject to the new rulebook. They are mainly influenced in the manufacturing and distribution processes of financial products.

Although, the product governance regime is applied to MiFID firms, it indirectly affects also non-MiFID firms when these firms have a business relationship with MiFID firms and when they distribute financial products that are produced by manufacturer MiFID firms.

The relationship between MiFID and non-MiFID firms is very common; nowadays, due to the technology improvement, the advanced tools of communication and the transportation routes are gradually getting more efficient, it is very easy to implement a global business network among firms located in different European countries or even in different continents.

In the case of a non-MiFID firm has an affiliate MiFID firm as a means through which distributes financial products within the European Economic Area, are applied in any case the product governance rules. In a more detailed manner, a firm that distributes financial instruments that are manufactured by a firm that is not subject to product governance requirements, it must carry out a rigorous analysis and an accurate due diligence in order to provide the right level of protection in comparison to a situation where the product had been manufactured in respect of product governance obligations²⁸³.

²⁸¹ Sciarrone Alibrandi A., “*Dalla tutela informativa alla product governance: nuove strategie regolatorie dei rapporti tra clientela e intermediari finanziari*”, in Rivista della Regolazione dei mercati, Fascicolo 1, 2016.

²⁸² Sane R., Halan M., “*Misled and mis-sold: financial misbehaviour in retail banks?*”, in Journal of Comparative Economics 45, pp. 429-444, 2017.

²⁸³ Par. 60 of ESMA Guidelines on MiFID II product governance requirements, 5 February 2018.

Hence, following this latter case, if a product is designed and created by a firm that not fall under the product governance obligations, the distributor must in any case applies the product governance rules in a more prudence way because it represents the only guarantor of the application of product governance as a tool to protect end investors; these types of relationship with a non-MiFID firms could affect the classical information gathering process and the target market identification procedure:

- Information gathering process: the distributor has the duty to verify and check all the information received from manufacturer not subject to Directive 2014/65/EU (product governance requirements in particular) in order to ensure that the financial products are distributed to clients (the target market) in respect of the needs, characteristics and objectives.

In some cases, the information necessary for the distributor are not publicly available; in this situation, the distributor must implement a strategy in order to gather the information useful to complete the process. The most common strategy is to enter into an agreement with the manufacturer for the purpose of obtaining all relevant information to make a precise identification of the target market²⁸⁴.

The distributor can accept and use the information publicly available only if they are clear, trustworthy and produced in compliance with some regulatory and information requirements like Directive 2003/71/EC²⁸⁵ or “transparency” Directive 2004/109/EC²⁸⁶ that are amended by the more recent and precise Directive 2013/50/EU²⁸⁷. In general, the most common source of information is the KID.

- Target market identification: distributor has to identify the actual target market following the classical aforementioned guidelines even in the case that the manufacturer has not previously identified the potential target market²⁸⁸. The distributor has to define

²⁸⁴ Art. 10 (2) of Commission Delegated Directive (EU) 2017/593 of 7 April 2016.

²⁸⁵ Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC.

²⁸⁶ Directive 2004/109/EC of the European Parliament and of the of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC.

²⁸⁷ Directive 2013/50/EU of the European Parliament and of the Council of 22 October 2013 amending Directive 2004/109/EC of the European Parliament and of the Council on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, Directive 2003/71/EC of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading and Commission Directive 2007/14/EC laying down detailed rules for the implementation of certain provisions of Directive 2004/109/EC Text with EEA relevance.

²⁸⁸ Art. 10 (1) of Commission Delegated Directive (EU) 2017/593 of 7 April 2016.

its own actual target market even when it didn't receive the right description or information about the approval process²⁸⁹.

The whole burden of assessment, check and reliability of the information received from a non-MiFID firm have come to be held by the distributor.

The obligations of the distributor in the information gathering process and target market identification must be respected in a proportionate manner with respect to the complexity of the product involved and for products sold in the primary or secondary market.

The stream of information between market players covers a central role in the financial environment and it is stressed in the new legislative package²⁹⁰. As the flows of information between the intermediary and end client are fundamental for a sound relationship, also those implemented in the previous steps are necessary in order to allow for a correct functioning as a whole.

In fact ESMA has asserted that a firm, representing in the context the last player in the business chain before the end client, if it covers a position in which it can't receive the right amount of information by a manufacturer that is not subject to product governance regime and, as a consequence of this, it is not able to respect the rules of MiFID II, the distributor shouldn't offer these types of products to end clients²⁹¹.

Hence, the relationship implemented by firms in a business chain covers a fundamental mechanism in the whole process. More accurate is the flow of information exchanged, more tailor-made and precise will be the products in relation to the end clients' needs, characteristics and objectives.

In a general economic environment, the chain of firms becomes a unique and single operator; in this view, the competition among market players is not anymore based on the competition between the single firms but become a competition between groups of firms. So, the exchange of information inside the chain can grant an improvement in the competitiveness.

Again, in this context, as I have said before, the manufacturer, the first unit in the chain, has the duty to choose the right distributor in order to reach the end client in the best manner and for the purpose of delivering a product that meets the features of clients.

Conversely, the firms didn't always have the convenience to deliver all the information. Some of these data can be considered as private information and probably is not diffused in the right manner to another unit in the chain. In this way, in order to defend information that is retained

²⁸⁹ Par. 61 of ESMA Guidelines on MiFID II product governance requirements, 5 February 2018.

²⁹⁰ Annunziata F., "*Le nuove sfide della MiFID II*", in *Rivista di Diritto Bancario*, Marzo 2018.

²⁹¹ Par. 63 of ESMA Guidelines on MiFID II product governance requirements, 5 February 2018.

as private, there will be a problem that will harm the end client. In fact, as I have reported before, in order to grant a perfect match between the financial product and the target market at the end of the chain, it is necessary a perfect exchange of information between manufacturer and distributor.

It's probable, in some cases, that the firms involved in the process, in order to defend some private information, don't deliver the right stream of information damaging the main goal of the product governance regime, namely improve the investor protection ensuring tailor-made products.

This delicate problem of privacy could be an infinite hole in the regulation; on one side the investment firm, by definition, has to produce profit for the right functioning of business system; on the other side, product governance requires to investment firm to act in the best interest of client.

After this digression in the delicate privacy system, it prompts the question as to what the end aim of investment firm is.

In a relationship between non-MiFID and MiFID firms, the problem is more stressed because the MiFID firm has to gather the maximum amount of information in order to apply the product governance regime and this is probably more difficult with respect to the collection of information from a MiFID firm.

A perfect exchange of information is possible maybe in a utopian model of financial system.

The product governance regime requires a perfect and precise exchange of information between manufacturer and distributor in order to meet the specific features of the end client.

In my opinion, this is impossible because even if we consider the business chain as a unique player, actually it is composed by different single firms that must defend their own interests and produce profit, that by definition is the main goal of any firm. In this context, the effort of product governance in the field of investor protection is evident but there is no a certain guarantee of the perfect investor protection. I have also talked about the product intervention, that should intervene in case of investment firms sell or could sell a dangerous financial product to the end client; also in this case the power of the product intervention is limited; for example, although a specific product is approved, because it has passed the inspection and the assessment imposed by the new legislative package, there is not the certainty that this product was designed, created, marketed and sold following the best approach. There will be always a manoeuvre margin carried out by the investment firms on which they can operate respecting the rules but not reaching always the maximum degree of "act in the best interest of client".

Similar events can occur, for example, when there is not a perfect exchange of information between the parties involved in the manufacturing and distribution process. This means that,

even if the obligations are met, there is no certainty that investment firms have acted in the best possible way.

Conclusion

In this dissertation I have tried to analyse the new Market in Financial Instrument Directive (MiFID II) starting with a brief explanation of the old directive and in particular considering the principal flaws and shortcomings highlighted through the financial crisis. These weaknesses of the old legislative framework represent the starting point for the restructuring of the old directive towards a more complete and regulated legislative package. Hence, the Regulator, after the global financial crisis, has attempted to solve any type of legal hole through the restyling of some provisions and the introduction of new tools.

The well-known MiFID II is originated by a series of different directives and regulations that must be considered together in order to have a complete view of the new legislative package. As reported in the old directive, the main fields of interest around which the new legislative package was implemented are very similar with respect to the old framework. The investor protection remains one of the most important pillar in MiFID II together with the information regime and market transparency rules. The global financial crisis had highlighted the shortcomings in the previous legislative framework and many rigorous measures and actions were necessary in order to restore the investor confidence and guarantee a correct functioning of financial system with sound and solid basis.

In particular, to reach these type of objectives, the Regulator has implemented some innovative measures, many of which have amended some rules of the old directive, as well as other important innovative tools and regimes; the most relevant concerns product governance regime and product intervention powers.

The new framework presents a high degree of dependence among rules and it often happens that some of them must be applied in accordance with others; even the main goals of the Regulator are strictly linked. In fact, for example, in order to reach a high level of investor protection is necessary a solid transparency regime and a continuous and precise exchange of information among market players; this means that the provisions are dependent on each other and the application of one particular rule, for example, implies the correct implementation of another provision.

Coming back to the product governance and product intervention regime, in this dissertation I have focused the attention on the former one analysing in detail each component and procedure that compose the process, from the initial engineering and product design phases to the post-selling and monitoring phases. Within this complex process are indirectly included a relevant number of provisions and rules that normally are applied separately in different legal contexts

like rules about information flow and transparency. In some way it seems that product governance regime embeds a huge number of provisions implemented in MiFID II. These types of provisions, even if are indirectly applied, cover a fundamental and central role for the end goal of product governance.

Product governance, that was created with the end aim to guarantee to end clients a quasi-tailor-made financial product in relation to their needs, features and characteristics, is the tool through which the Regulator has attempted to reach a twofold objective, namely the improvement of the investor protection and the correlated correct functioning of the whole financial market. If we consider the product governance as a starting point of this objective, at the origin of this path it is necessary an efficient information flow among the players involved.

Hence, as I have said previously, not only the entire MiFID II must be analysed in a wide approach but also the product governance regime must be implemented and read through a broad legislative analysis and taken into consideration a disparate number of provisions.

For a perfect functioning of product governance process is necessary a perfect exchange of information between manufacturers and distributors but the stream of information can be hampered by privacy problems.

Since product governance is a very recently innovation, introduced in January 2018, it is too early to judge the effective results of this new regime. Although the product governance will improve investor protection due to the introduction of a strict assessment of the procedure and the intervention power in the hands of authorities in case of failure of the process, I think that this new regime has some limits. The most important one regards the aforementioned problem of information exchanged by players.

The problem of privacy can't be underestimated because cover a central role in all exchange of information models. All the firms that compose the business chain, under the product governance regime, should exchange a stream of information as much as possible precise and exhaustive in order to comply with the obligations imposed by the Regulator. They should act in the best interest of client and create and deliver a perfect instrument in relation to the needs, characteristics and objectives of the target market but this requires a very high degree of cooperation that it can sometimes harm the own main goals of any single firm, namely to make profit.

Hence, I think, the Regulator should implement a product governance regime basing on an incentive system that allow firms, in the same value chain, to disclose all the information needed for a creation and distribution of a product with a high matching-degree with the target market but at the same time ensuring the own goals of each firms.

This hypothetical system, that in this my personal opinion could be considered as a “modified” product governance regime, should provide a balanced model in order to grant to both the sides of economic environment, investment firms on one hand and end clients on the other, to obtain better results pursuing in any case they own goals.

Focusing the attention on the side of investment firms, the Regulator should be able to ensure that a hypothetic maximum effort of the firms to design and distribute the product doesn’t lead to a loss of profit due to the disclosure of private information. Considering the other side of market instead, the Regulator should ensure a perfect match between the features of products manufactured with the needs of end clients under the product governance regime but in accordance with the privacy legal framework.

This model is probably a “pipe dream” because it would require too rigid legal framework; in conclusion I think that, although product governance has improved and will improve even more the investor protection, it is probably never lead to a complete investor protection because, in my opinion, each investment firm, even in compliance with the obligations dictated by the Regulator, will always act in its own best interest rather than in the best interest of client.

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