

PROD rules for advisers

A summary
of the FCA's
rules for
PROD 3 and 4

The Product Intervention and Product Governance Sourcebook (PROD) rules were introduced in January 2018 as part of the wider MiFID II provisions.

Their purpose is to improve firms' product oversight and governance processes – the systems and controls they have in place to design, approve, market and manage a product throughout its lifecycle to ensure it meets legal and regulatory requirements. These rules lay down a number of requirements for firms which either 'manufacture' or 'distribute' investment and insurance products. The FCA believes that good product governance should result in products that:

- Meet the needs of one or more identifiable target markets
- Are sold to clients in the target markets by appropriate distribution channels
- Deliver appropriate client outcomes.

Research from various sources suggests that many advisers are unaware of the FCA's PROD rules and how these apply to them. We therefore give a high-level summary of the main implications of the FCA's PROD rules (and guidance) for advice firms here, although we strongly recommend that you are fully conversant with the [FCA's Sourcebook](#) as it is vital that you are aware of your firm's obligations.

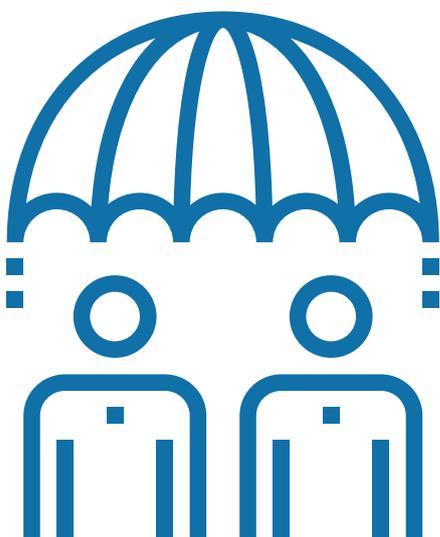
We also detail on page 7 ways in which we help your firm meet its PROD requirements.

The different elements of PROD

The Sourcebook is divided into a number of different parts and the two areas we concentrate on within this guide are:

PROD 3

This relates to the manufacture and distribution of financial instruments, structured deposits and investment services. Firms should check the FCA's definitions of these terms but, for example, the distribution of collective investments, shares, bonds and portfolio management services fall under PROD 3.



PROD 4

This applies to insurers and insurance intermediaries and relates to the manufacture and distribution of insurance products. Again, firms should check the FCA's definitions to see what constitutes an insurance product.

PROD 3

Product Governance: MiFID

Different rules apply to manufacturers and distributors of investment products and services (a firm can be both).

Manufacturers of products

In most instances, advice firms will not be subject to the rules/guidance relating to manufacturers. However, as advisers need to assess and understand the products they distribute, they should be aware of how they are manufactured. The general requirements for manufacturers are as follows:

A manufacturer must:

- ensure that its products are designed to meet the needs of an identified target market of end clients
- ensure that the distribution strategy is compatible with the identified target market
- take reasonable steps to ensure that the product is distributed to the identified target market.

A manufacturer must also make available to any distributor:

- all appropriate information on the financial instrument
- all appropriate information on the product approval process
- the identified target market of the product
- information about the appropriate distribution channels for the product.

In addition, they must ensure the information is of an adequate standard to enable distributors to understand and recommend/sell the product properly.

A manufacturer must regularly review its products, taking into account any event that could materially affect the potential risk to the identified target markets.

Distributors of investment products and services

General

A distributor must:

- understand the financial instruments it distributes to clients
- assess the compatibility of the product with the needs of the client, taking into account the manufacturer's identified target market of end clients
- ensure that products are distributed only when this is in the best interests of the client.

A distributor should consider what impact the manufacturer could have on the end client in terms of charges or the financial strength of the manufacturer, or possibly, where information is available to the distributor, how efficiently and reliably the manufacturer will deal with the distributor or end client at the point of sale (or subsequently, such as when queries/complaints arise, claims are made, or a financial instrument reaches maturity).

Obtaining information from manufacturers

Distributors must obtain information from manufacturers in order to gain the necessary understanding and knowledge of the product so that it is distributed in accordance with the needs, characteristics and objectives of the target market.

To ensure sufficient information is obtained about the product, the distributor:

- should consider whether they understand the manufacturer's materials
- should ask for additional information or training where necessary
- should not distribute the product or service if they do not understand it sufficiently
- should consider, when providing information to another distributor in the chain, how that distributor will use the information.

Distributing financial instruments manufactured by non-MiFID firms

Distributors must take all reasonable steps to comply with the PROD 3 distributor rules when distributing financial instruments manufactured by any firm to which MiFID manufacturer product governance requirements do not apply.

Target market and distribution strategy

Distributors must determine the target market for the product, even if the target market was not defined by the manufacturer.

Distributors must identify the target market and their distribution strategy using:

- the information obtained from manufacturers
- information they have on their own clients.

In identifying the target market and creating a distribution strategy, distributors should consider:

- the nature of the products and how they fit with end clients' needs and risk appetite
- the impact of charges on end clients
- the financial strength of the manufacturer
- where information is available, how efficiently and reliably the manufacturer will deal with the end client at the point of sale or subsequently, such as when complaints arise, claims are made or the financial instrument reaches maturity.

The target market should be identified at a sufficiently granular level.

Distributors must have in place adequate product governance arrangements to ensure that:

- the products/services they intend to distribute are compatible with the needs, characteristics and objectives of the identified target market
- the intended distribution strategy is consistent with the identified target market.

Distributors must appropriately identify and assess the circumstances and needs of the clients they intend to focus on to ensure that their clients' interests are not compromised as a result of commercial or funding pressures.

Distributors must identify any groups of end clients for whose needs, characteristics and objectives are not compatible with the product/service.

Distributors must periodically review their product governance arrangements and must take appropriate actions where necessary to ensure they remain robust and fit for their purpose.

In the design of investment services, to help clients make an informed decision, firms should consider the support clients need before they reach the product selection part of the process.

Distributors must have procedures and measures in place to ensure all applicable rules are complied with, including those relating to disclosure, suitability, appropriateness, inducements and conflicts of interest (particularly when distributing new products or where there are variations to the investment services provided).

Oversight and training requirements

The development and periodic review of product governance arrangements must be monitored by the compliance oversight function of a firm in order to detect any risk of failure by the distributor to comply with the applicable provisions of PROD.

The management body of a distributor must have effective control over the firm's product governance process to determine the products it offers or recommends and the investment services it provides to the respective target markets.

All relevant staff must possess the necessary expertise to understand:

- the characteristics and risks of the products that the firm intends to distribute
- the investment services provided by the firm
- the needs, characteristics and objectives of the identified target market.

Compliance reports

Compliance reports to the management body must include information about the products distributed and the investment services provided by the firm and should be made available to the competent authorities (e.g. the regulator) on request.

Post-sale review

Distributors must regularly review the products/services they distribute or provide, taking into account any event that could materially affect the potential risk to the identified target market.

If a target market is wrongly identified, or the product/investment service no longer meets the circumstances of the target market, the distributor must at least reconsider the target market and/or update its product governance arrangements. Action may be needed where the product becomes very illiquid/volatile due to market changes.

Information sharing

A distributor must provide to the manufacturer of each financial instrument it distributes:

- information on sales (including any made outside of the target market)
- where appropriate, information on its post-sale reviews.

Distributors should provide the data necessary for the manufacturer to review the product and check that it remains consistent with the needs, characteristics and objectives of the target market (it is not necessary to report every sale). Relevant information could include:

- summary information of the types of clients
- a summary of complaints received.

PROD 4

Product Governance: Insurance Distribution Directive

Manufacturers of insurance products

In a similar way to PROD 3, manufacturers of insurance products are subject to rules on, for example, product governance, the identification of target markets, product testing, ongoing monitoring and reviews, and the disclosure of information to distributors.

More information can be found within the [FCA's Sourcebook](#).

Distributors of insurance products

Where a firm distributes insurance products which it does not manufacture, it must have in place adequate arrangements to obtain from the manufacturer:

- all appropriate information on the product
- all appropriate information on the product approval process; and
- the identified target market of the product.

The distributor must also have in place adequate arrangements to understand:

- the characteristics of each product; and
- the identified target market of each product.

Distributors should obtain sufficient, adequate and reliable information from the manufacturer so that the product will be distributed in accordance with the characteristics, objectives and needs of the target market.

In ensuring they have sufficient information and understanding of a product, distributors:

- should consider whether they understand the materials provided by the manufacturer
- should ask for additional information or training where necessary
- should not distribute the insurance product if they do not understand it sufficiently
- when providing information to another distributor in the chain, should consider how that distributor will use the information.

Any specific distribution strategy set up or applied by distributors shall be in accordance with the strategy set up and the target market identified by the manufacturer.

The body or structure responsible for insurance distribution within the firm shall endorse and be ultimately responsible for establishing, implementing and reviewing the product distribution arrangements and shall continuously verify internal compliance with those arrangements.

Distributors shall regularly review their product distribution arrangements to ensure that they are still valid and up to date, amending those arrangements where appropriate.

If a distributor becomes aware that an insurance product is not in line with the interests, objectives and characteristics of its identified target market or becomes aware of other product-related circumstances that may adversely affect the customer, they should promptly inform the manufacturer and, where appropriate, amend their distribution strategy.

Manufacturers and distributors should take appropriate action in order to avert the risk of consumer detriment when they consider that the product is not, or is no longer, aligned with the interests, objectives and characteristics of the identified target market.

Relevant actions taken by firms in relation to distribution shall be documented, kept for audit purposes and made available to the competent authorities (e.g. the regulator) upon request.

Distributors shall set out the product distribution arrangements in a written document and make this available to their relevant staff.

These rules do not affect other requirements in the FCA Handbook applying to firms distributing insurance products (including those relating to disclosure, suitability, appropriateness, inducements and conflicts of interest).

The European MiFID Template (EMT)

In order to standardise the categorisation of target markets for investment products, manufacturers, distributors and national industry associations across Europe came together to jointly develop the European MiFID Template (EMT). This template is commonly used by manufacturers in the UK, including Fidelity, to help distributors research and select products that could be appropriate for their clients.

The template gives the following options in terms of defining a target market for products that are intended to be distributed in the UK:

Investor type	<ul style="list-style-type: none"> ■ Retail ■ Professional ■ Eligible Counterparty
Knowledge and/or experience	<ul style="list-style-type: none"> ■ Basic Investor ■ Informed Investor ■ Advanced Investor
Client ability to bear losses	<ul style="list-style-type: none"> ■ Clients who cannot bear capital loss ■ Clients who can bear limited capital loss ■ Limited capital loss level (for products with a full or partial capital guarantee) ■ Clients who do not need a capital guarantee ■ Clients who can bear a loss beyond the capital
Risk tolerance	<ul style="list-style-type: none"> ■ PRIIPS SRI ■ UCITS SRRI ■ High/Medium/Low for non PRIIPS and non UCITS
Objectives and needs	<ul style="list-style-type: none"> ■ Clients looking for preservation ■ Clients looking for capital growth ■ Clients looking for income ■ Hedging ■ Option or leveraged return ■ Minimum recommended holding period (short/medium/long term) ■ Compatible with clients having ESG preferences ■ Other specific investment needs (e.g. Islamic banking)
Distribution strategy	<ul style="list-style-type: none"> ■ Execution only ■ Execution with appropriateness test or non-advised services ■ Investment advice ■ Portfolio management

Firms can download the EMT from [FinDatEx](#), a joint structure established by representatives of the European financial services sector.

Helping you meet your PROD requirements

In order to help you assess the compatibility of an investment with the needs of your clients, we provide a downloadable report that specifies the end client target market for each fund available on our platform as defined by the manufacturer (fund provider). To access this report, which follows the European MiFID Template, simply log into Client Management and 'Request a Report' through our Reporting Services facility. You will find the 'MiFID Fund List' under the 'Adhoc Reports' section.

For further information, please visit our [Reporting services](#) support area.

Please note that FundsNetwork does not offer access to funds/products where the manufacturer has clearly indicated that retail investors are excluded from the target market.

We also assist by reporting on firms' behalf any sales made outside of the target market (by client type or distribution channel).

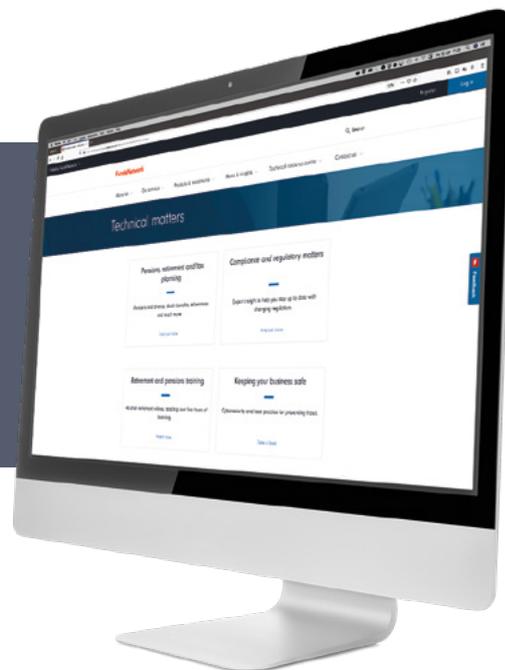
FundsNetwork's view

The importance of segmenting your client bank

The FCA's PROD rules are primarily focused on ensuring that products and services are properly understood and are distributed to the appropriate target market. Good client segmentation is therefore vital – firms need to ensure that their clients are only offered/recommended products compatible with their needs. Firms therefore need to take account of the segmentation of their client bank when designing the investment/retirement propositions and the advisory services they offer and use (which includes the platform selection process). It is also worth noting that the segmentation process needs to be clearly documented as firms may need to demonstrate to the regulator how they have identified their target markets.

One of our goals is to help advisers and paraplanners understand the impact of regulatory change. Visit our Technical matters hub for more analysis on regulatory initiatives affecting the industry.

fundsnetwork.co.uk/technicalmatters



Important information

This document provides information and is only intended to provide an overview of the current law in this area and does not constitute financial advice, tax advice or legal advice, or provide any recommendations. This document represents a summary of our understanding of the relevant regulations at the date of its last review (January 2020). Regulations and guidance are often subject to change and may change in future. Individuals should check that rules and regulations have not changed.

