



European Securities and
Markets Authority

Consultation Paper

Draft guidelines on MiFID II product governance requirements



Responding to this paper

ESMA invites comments on all matters in this paper and in particular on the specific questions summarised in Annex 1. Comments are most helpful if they:

1. respond to the question stated;
2. indicate the specific question to which the comment relates;
3. contain a clear rationale; and
4. describe any alternatives ESMA should consider.

ESMA will consider all comments received by **5 January 2017**.

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input - Consultations'.

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading [Legal Notice](#).

Who should read this paper

This paper is primarily of interest to competent authorities and firms that are subject to Directive 2014/65/EU of the European Parliament and of the Council¹ (MiFID II). In particular, this paper is addressed to investment firms and credit institutions performing investment services and activities and their staff; especially, firms which manufacture financial instruments or structured deposits for sale to clients as well as the firms which distribute them. This paper is also important for trade associations, investors, and consumer groups, because the guidelines seek to implement enhanced provisions, to ensure investor protection with potential impacts for anyone engaged in the dealing with or processing of financial instruments.

¹ Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (OJ L 173, 12.06.2014, p. 349).



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1 Executive Summary

Reasons for publication

Directive 2014/65/EU on markets in financial instruments (MiFID II) has introduced product governance requirements to ensure that firms which manufacture and distribute financial instruments act in the clients' best interests during all the stages of the life-cycle of products or services.

In accordance with Article 16(2) of the European Securities and Markets Authority (ESMA) Regulation, this paper sets out, for consultation, draft ESMA guidelines on certain aspects of the MiFID II product governance requirements.

While the MiFID II product governance requirements, as laid down mainly in Article 16(3) and Article 24(2) of MiFID II, cover a broad range of topics, ESMA has decided to develop draft guidelines which mainly address the 'target market assessment', as this aspect was identified as the most important one for ensuring the common, uniform and consistent application of the above-mentioned articles.

By pursuing the objective of ensuring a consistent and harmonised implementation and application of the new requirements in the area of product governance, the proposed Guidelines will make sure that the objectives of MiFID II and the MiFID II Delegated Directive can be efficiently achieved. ESMA believes that the implementation of the target market assessment by market participants will benefit from additional clarity.

Contents

Annex 1 lists all the questions set out in the consultation paper; Annex 2 contains the high-level cost-benefit analysis; Annex 3 contains the full text of the draft guidelines; Annex 4 contains some practical examples and case studies related to the application of certain aspects of the guidelines.

Next Steps

ESMA will consider the feedback it received to this consultation in Q1 2017 and expects to publish a final report in Q1/Q2 2017.

2 Background on the draft guidelines

General

1. The financial crisis has shown that there are instances where the application of conduct of business rules in the context of the provision of investment services to single clients may be insufficient to ensure that firms fulfil their duty of acting in the best interests of their clients. Therefore, MiFID II, in Article 16(3) and Article 24(2), introduced product governance obligations for manufacturers and distributors, which were further specified in Articles 9 and 10 of the Commission Delegated Directive² (MiFID II Delegated Directive), with the objective of enhancing the level of protection of investors by way of requiring firms to take responsibility, from the beginning, that products and the related services are only offered in the interest of clients, which should not be prejudiced by firms' own commercial, funding or prudential needs.³
2. The objective of the product governance requirements is to ensure that firms, which manufacture and distribute financial instruments and structured deposits, act in the clients' best interests during all the stages of the life-cycle of products or services.
3. The MiFID II requirements on product governance cover arrangements for:
 - firms to adopt when manufacturing products ('product governance obligations for manufacturers'); and
 - firms to adopt when deciding the range of products and services they intend to offer to clients and when offering or recommending such products to clients ('product governance obligations for distributors').
4. MiFID II clearly notes that the requirements on product governance apply without prejudice to any assessment of appropriateness or suitability to be subsequently carried out by the firm in the provision of investment services to each client, on the basis of their personal needs, characteristics and objectives.
5. The product governance requirements, as laid down in Articles 16(3) and 24(2) of MiFID II as well as in Articles 9 and 10 of the MiFID II Delegated Directive, cover a broad range of topics, both product and process related. However, these guidelines mainly address the target market assessment, as this aspect was identified as the most important one for ensuring the common, uniform and consistent application of the above-mentioned articles. Furthermore, establishing consistent, efficient and effective supervisory practices on the

² Commission Delegated Directive of 7.4.2016 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. The Commission Delegated Directive was published on 7 April 2016 and no objection has been expressed by the European Parliament or the Council on the MiFID II Delegate Directive and Delegated Regulation within the period set in Article 89 of MiFID II.

³ In particular, Article 24(2) of MiFID II stipulates that distributors shall '*ensure that financial instruments are offered or recommended only when this is in the interest of the client*'; Subparagraph 1 of Article 10(2) of the MiFID II Delegated Directive further requires distributors to '*appropriately identify and assess the circumstances and needs of the clients they intend to focus on, so as to ensure that clients' interests are not compromised as a result of commercial or funding pressures*'.

target market assessment is important, especially given the fact that the implementation of the target market assessment by market participants is complex and will benefit from further clarity. Nevertheless, the focus on the target market assessment is without prejudice to other potential ESMA work on other aspects of the MiFID II product governance requirements.

6. This paper, in accordance with Article 16(2) of the ESMA Regulation⁴, sets out for consultation draft ESMA guidelines on product governance requirements in the context of MiFID II rules on organisational requirements and conduct of business.
7. ESMA considers that competent authorities should ensure that firms act in accordance with the best interests of their clients and are able to comply with their obligations under MiFID II. ESMA considers that these guidelines will assist firms in acting in accordance with the best interests of their clients and meeting their obligations under MiFID II.
8. These guidelines should be applied in a proportionate manner, taking into account the nature, scale and complexity of a firm's business and the nature and range of financial services and activities undertaken.
9. ESMA believes that it is useful to provide examples in order to explain some areas firms could likely consider when identifying the target market. These examples do not form part of the guidelines but instead aim to assist firms in understanding how the requirements in the guidelines can be met.
10. Article 10 of the MiFID II Delegated Directive applies the distributor product governance provisions to investment services offered by firms, as well as to financial instruments and structured deposits. Firms will need to consider which aspects of the provisions are relevant to their investment services and activities.

Guidelines for manufacturers

Identification of the potential target market by the manufacturer

11. ESMA has set out in these draft guidelines a list of six categories that manufacturers should use as a basis for defining the target market for their products:
 - The type of client to whom the product is targeted;
 - Knowledge and experience;
 - Financial situation, with a focus on the ability to bear losses;

⁴ 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), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC.

- Risk tolerance and compatibility of the risk/reward profile of the product with the target market;
 - Clients' objectives;
 - Clients' needs.
12. The manufacturer usually does not have a direct client contact and thus has no detailed, specific and individual information about the client base. Hence, its target market identification may be more abstract in the above-mentioned categories. The guidelines do not prescribe how to define each category for each product but leave sufficient flexibility for manufacturers to adapt their application to each individual case. Therefore, the descriptions of the categories serve as examples for orientation purposes.
13. The target market identification is distinct and serves a different purpose from the suitability and appropriateness tests (where applicable). In principle however, there is already an established market practice for some of the above categories as they are used to conduct suitability or appropriateness tests and can thus, in an abstract way, be drawn upon for target market identification. For example, concerning the "risk tolerance", many firms classify their clients into a system of "risk-attitude categories" for suitability purposes. For a detailed description of the six categories, see paragraph 16 of the draft guidelines in Annex 3.
14. When identifying the target market, it is acceptable for firms to only identify the category of clients that warrants most protection. For example, a product that can be targeted at retail clients, will be capable of being targeted at professional clients as well, and the manufacturer will not necessarily need to explicitly specify this.
15. ESMA believes that the above-mentioned six categories should form the minimum basis for the target market assessment: each manufacturer should assess the target market at least in each of the categories listed above. Additional categories should be added if, in the manufacturer's view, they are important to describe the product.

Q1: Do you agree with the list of categories that manufacturers should use as a basis for defining the target market for their products? If not, please explain what changes should be made to the list and why.

Identification of the potential target market: differentiation on the basis of the nature of the product manufactured

16. The identification of the target market assessment should be done in an appropriate and proportionate manner, considering the nature of the investment product.

17. Consequently, for simpler, more common products, such as ordinary shares, it is likely that the target market will be identified with less detail. In many cases, it is understood that such products can be compatible with the mass retail market. For more complicated products, such as CFDs or structured products with complicated return profiles, the target market should be identified in more detail.⁵
18. The following are two examples of how the assessment of simpler and more common products, could be done in practice:
- a) For some types of financial products, it is possible to identify the above-mentioned target market categories on the basis of a common approach for all financial instruments of one type, if such products are sufficiently comparable (for example due to an external benchmark, such as a stock-exchange segment with certain requirements or product features). Where relevant, the possibility to choose a common approach could apply to different target market categories (for example an external benchmark would lead to comparability regarding the target market category of “risk tolerance” while a stock-exchange segment including only ethical investments would lead to comparability regarding the target market category “needs”).
 - b) Depending on the financial product, the description of one or more of the above mentioned categories may be more generic. The simpler a product is, the less detailed the description of each category may be.

Q2: Do you agree with the approach proposed in paragraphs 18-20 of the draft guidelines on how to take the products’ nature into account? If not, please explain what changes should be made and why.

Articulation between the distribution strategy of the manufacturer and its definition of the target market

19. The manufacturer should define its distribution strategy so that this strategy favours the sale of each product to the target market of the product. In defining the distribution strategy, a manufacturer should determine the extent of clients’ information available to the distributor in order to properly assess the target clients for its product.
20. Hence, the manufacturer should propose the type of investment service through which the target clients should or could usually acquire the financial instrument (advised, non-advised). If the product is deemed appropriate for a sale without advice (i.e. via “execution only” or “with appropriateness test”) the firm should also specify the preferred acquisition

⁵ See Recital 19 of the MiFID II Delegated Directive.

channel (face-to-face, via telephone, online, etc.) and, if relevant, specific design features of the acquisition channel.

21. For example, it should be specified in the target market if certain acquisition channels may or may not be appropriate to protect the client from precipitance. If online sales were specified as an appropriate acquisition channel, the manufacturer should, for example, make recommendations about “dos” (for example, the amount/quality of information or explanations about the product, warnings, listed product alternatives) and “don’ts” (for example, interactive elements such as continuous red and green flashing indicating market price changes may be appropriate for sophisticated clients but may not for less sophisticated clients as they could distract from the main features of the product) of the website where the product is offered or listed.

Guidelines for distributors

Timing and relationship between the target market assessment of the distributor with other product governance processes

22. According to Article 10(2) of MiFID II Delegated Directive, distributors shall “have in place adequate product governance arrangements to ensure that products and services they intend to offer or recommend are compatible with the needs, characteristics, and objectives of an identified target market and that the intended distribution strategy is consistent with the identified target market”.
23. Such arrangements apply at the early stage of the firm’s business cycle and before the actual offer of a certain product to clients, when the firm’s management body decides which products are going to be sold, to whom and how, i.e. through the provision of which investment services. This is in line with Article 9(3)(b) of MiFID II, which clarifies that the management body is required to “define, approve and oversee...a policy as to services, activities, products and operations offered or provided, in accordance with (...) the characteristics and needs of the clients of the firm to whom they will be offered or provided...”.
24. Product governance decisions taken by the management body affect all relevant firm’s processes and procedures, including for example, the definition of budgeting objectives and staff remuneration policies.⁶ Product governance arrangements directly influence the way in which the firm’s business is conducted, as the management body’s resolutions are implemented along the firm’s decision chain and hierarchy, from senior management to customer-facing staff.
25. As a result, and as clarified in Recital 15 of the MiFID II Delegated Directive, effective product governance arrangements will reduce the risk of failure of other existing rules, such

⁶ When addressing staff remuneration policies, Article 24(10) of MiFID II specifies that firms ‘shall not make any arrangement by way of remuneration, sales targets or otherwise that could provide an incentive to its staff to recommend a particular financial instrument to a retail client when the investment firm could offer a different financial instrument which would better meet that client’s needs’.

as suitability and appropriateness, which apply subsequently, at the point of sale, in the context of the provision of investment services to each individual client⁷. Indeed, the identification, for a given product, of its target market and related distribution strategy should ensure that the product ends up with the ‘correct’ type of customers, for whose needs and objectives it had been designed, rather than other clients for whom the product may not be compatible.

Identification of the target market by the distributor: categories to be considered

26. ESMA is of the opinion that, when defining the target market, distributors should use at least the same six categories as manufacturers (as mentioned above). Distributors, however, should define the target market in a more granular way, taking the “potential” target market from the manufacturer and its boundaries as a starting point. This results in a more concrete actual target market, based on the information the distributor has and its knowledge about its client base.

27. To this end, distributors should conduct a thorough analysis of the characteristics of its client base, i.e. current/existing clients as well as potential clients and should use any information and data deemed reasonably useful and available for this purpose that may be at the distributors’ disposal and gathered through investment or ancillary services (for example, suitability/appropriateness questionnaires completed in relation to previously executed transactions with clients - where available - depending on the type of services provided to them). In addition, the distributor could use any information and data deemed reasonably useful and available for this purpose that may be at the distributors’ disposal and gathered through other sources other than investment or ancillary services, such as customer relationship management activities, anti-money laundering questionnaires, clients’ complaints database, etc.

Q3: Do you agree with the proposed method for the identification of the target market by the distributor?

Identification of the potential target market: differentiation on the basis of the nature of the product distributed

28. The identification of the target market assessment by the distributor should also be done in an appropriate and proportionate manner, considering the nature of the investment product, in a way similar to that described in the analogue section for manufacturers.

Hedging, portfolio diversification and other client specific features

29. Many investors think about the different parts of their portfolio in different ways. For example, they may want investments to be more liquid and lower risk for short-term needs,

⁷ Specifically, the mentioned Recital 15 states ‘in order to avoid and reduce from an early stage potential risks of failure to comply with investor protection rules, investment firms manufacturing and distributing financial instruments should comply with product governance requirements’.

be willing to take a medium level of risk for most of their investment portfolio and be willing to speculate with a small, but distinct, part of their portfolio. The target market for a product could, therefore, be relevant in relation to certain components of investors' investment strategies.

30. ESMA considers it appropriate to clarify in the explanatory section of the guidelines that the target market assessment is product-related and is aimed at a group of target clients. The perspective of the target market assessment is the individual product. Personal features of clients are to be considered at the individual point of sale, for example, in the suitability or appropriateness tests and may, in certain cases, lead to permissible deviations between general target market identification and the individual eligibility of the client if the recommendation or sale of the product fulfils all other legal requirements (including those relating to disclosure, suitability or appropriateness, identification and management of conflicts of interest and inducements).
31. For example, a certain structured note is very risky. In the target market category "risk tolerance" the manufacturer specified "risk category 8" (in its nomenclature, this would be a "very speculative", "risky" product). An investment advisor advises a client who is prepared only to take risks regarding a limited part of his portfolio (the client may therefore invest only in instruments that are "risk category 5" and below). The portfolio of the client consists of 90% very conservative, low risk investments. Even though the client would not be within the target market for the structured note, the advisor may recommend the product for diversification purposes where this is compliant with the MiFID suitability requirements and in particular, the client's investment objectives. In following a diversification purpose, the adviser may come to the conclusion that the product is suitable in the individual case of the client.
32. These situations above should be justified by the individual facts of the case. They should not occur on a regular basis. When a product is distributed outside the target market, the reason for the deviation should be clearly documented and included in the suitability report (where applicable). Indeed, it would be expected that, if the *ex-ante* target market identification is correctly conducted, recommending and/or actively marketing products outside the target market, even if based on the consideration of the specific client's features, should be a limited occurrence. Moreover, firms should avoid distributing products outside the target market in cases where there are significant conflicts of interest (such as, for example, in self-placement situations, i.e. there is a sale of products issued by the firm itself or by other entities within the group). For details on other situations where it could happen that products are sold outside the target market, also refer to the 'Guidelines on the identification of the negative target market', paragraphs 58-65 of Annex 3.
33. Deviations from the target market (outside the "positive" or within the "negative") which may be relevant for the product governance process of the manufacturer (especially those which are not individually unique/exceptional) should be reported to the manufacturer.
34. There may also be situations where the same type of product could be used to meet different client's objectives or needs. For example, a certain Interest Rate Swap could satisfy the speculative objectives/needs of some clients with adequate knowledge and

understanding of the product and a financial situation that allows them to bear the possible risks related to the investment. The same Interest Rate Swap could also be targeted at clients with an adequate understanding of the instrument and the need of protection against interest rate risks inherent in other investments already within their portfolio of assets. In such instances, if the distributor has a thorough knowledge of the characteristics and circumstances of its client base, it could be possible for the firm to identify from the beginning more than one target market of end-clients, each of them characterised by different objectives or needs, rather than having to consider and justify the ‘deviation’ from one single, more generic target market. However, in line with the above-mentioned principle, in paragraph 30, aspects of “hedging” may only be included in the target market categories of “objectives” or “needs” if a product was explicitly designed for such a purpose and such features are objectively inherent in the product.

Q4: Do you agree with the suggested approach on hedging and portfolio diversification aspects? If not, please explain what changes should be made and why.

Identification and assessment of the target market by the distributor: interaction with the provision of different investment services

35. Distributors are required, by MiFID II, to identify and assess the circumstances and needs of the group of clients to whom they intend to offer or recommend a product (i.e. the ‘actual’ target market for that product), so as to ensure the compatibility between that product and the respective target clients. This obligation should apply in a proportionate manner depending, not only on the nature of the product, but also on the type of investment services that firms provide.

36. It is therefore expected that when distributors define their product assortment (i.e. the products that will be offered, to whom and through the provision of which investment services), they should pay particular attention to situations where they might not be able to conduct a thorough target market assessment by virtue of the type of services they provide. In particular, where firms only carry out execution services under appropriateness (for example through a brokerage platform), they should consider that they will usually be able to conduct an assessment of the actual target market, limited to the sole categories of knowledge and experience of clients; where they only conduct execution services under the execution-only regime, not even the assessment of clients’ knowledge and competence will usually be possible.⁸

⁸ As explained above (see paragraph 27 of the Background to the guidelines), for the definition of the target market, in addition to information gathered through investment or ancillary services, distributors could use any further information and data deemed reasonably useful that may be at their disposal and gathered through other sources. Therefore, even firms only providing investment services under appropriateness or execution-only regime, could be in the position to conduct a more thorough assessment of the target market.

Distribution strategy of the distributor

37. The distributor has to take the distribution strategy of the manufacturer into account and review it with a critical look. Ultimately, or in cases where a manufacturer is outside MiFID scope and thus does not deliver a distribution strategy, it has to define its own distribution strategy in light of its identified target market and relationship with its clients.
38. The distributor may deviate from the manufacturer's distribution strategy for a given product but it should generally do so only in a manner which increases the client's protection. For other deviations it is expected that the distributor would do so only after a thorough and documented analysis of the features of the products and of the target clients. Moreover, such a decision concerning the distribution of a certain product should be reported to the manufacturer as part of the distributor's obligation to provide the manufacturer with sales information.

Distribution of products manufactured by entities not subject to the MiFID II product governance requirements

39. Firms that distribute financial products that have been manufactured by entities which are not subject to the MiFID II product governance requirements are expected to perform the necessary due diligence so as to provide an appropriate level of service and security to their clients, compared to a situation where the product had been designed in accordance with the MiFID II product governance requirements. This means that the distributor has to define its own target market for such products and the distributor should conduct the necessary information gathering process to form an adequate information basis to fulfil this obligation.

Q5: Do you believe further guidance is needed on how distributors should apply product governance requirements for products manufactured by entities falling outside the scope of MiFID II?

Application of product governance requirements to the distribution of financial instruments that were manufactured or issued before the entry into application of MiFID II

40. MiFID II product governance obligations are to be observed from the date of application of MiFID II (3 January 2018). The distribution, after 3 January 2018, of products manufactured before that date should be treated in the same manner as the distribution of products that have been manufactured by entities not subject to the MiFID II product governance requirements (see above). However, a target market should be assigned by the manufacturer – when subject to MiFID II product governance requirements - to such products following the product review process that has to be conducted according to Article 16(3) of MiFID II.

41. Manufacturers and distributors should also consider the Joint Position of the European Supervisory Authorities on Manufacturers' Product Oversight & Governance Processes⁹ and the ESMA Opinion on Structured Retail Products - Good practices for product governance arrangements.¹⁰

Guidelines on transversal issues applicable to both manufacturer and distributor

Identification of the 'negative' target market by the manufacturer and distributor – clients for whom the investment products they manufacture and/or distribute are not compatible

42. Manufacturers and distributors have to identify a 'negative' target market – groups of clients who should not be targeted in the sale or distribution of the product. The methodology for identifying this negative target market is generally the same as for the identification of the positive market. Therefore, this leads to the identification of the positive target market, the negative target market and the area between the positive and negative target markets. There might be situations where products could, under certain circumstances and where all other legal requirements are met, be sold outside the 'positive' target market. However, these instances should be justified by the individual facts of the case and properly documented. As the "negative" target market is an explicit indication of those clients for whose needs, characteristics and objectives the product is not compatible and to whom, therefore, the product should not be distributed, the sale to investors within this group should be a rare occurrence and the justification for the deviation should be accordingly significant and is generally expected to be more substantiated than a justification for a sale outside the "positive" target market.

Q6: Do you agree with the proposed approach for the identification of the 'negative' target market?

Application of the target market requirements to investment firms dealing in wholesale markets (i.e. with professional clients and eligible counterparties)

43. The proposed guidelines explain how the target market requirements apply to the wholesale business, especially when professional clients and eligible counterparties act as end-clients or as part of the intermediation chain. As the target market needs to be identified for end-clients, such intermediate parties usually do not need to be specified as target clients if they do not act as end investors but pass products on as resellers. If such clients act as end-clients and buy products for themselves, the general methods described in the guidelines may be adapted in several ways to take into account the special knowledge and experience rules applicable to professional clients as described in Annex

⁹ JC-2013-77.

¹⁰ ESMA/2014/332.



2 of MiFID II, and the fact that, for eligible counterparties, Article 24(2) of MiFID II does not apply, likely leading to a less comprehensive target market identification for them.

Q7: Do you agree with this treatment of professional clients and eligible counterparties in the wholesale market?

Q8: Do you have any further comment or input on the draft guidelines?

3 Annexes

3.1 Annex 1 – Summary of questions

- Q1: Do you agree on the list of categories that manufactures should use as a basis for defining the target market for their products? If not, please explain what changes should be made to the list and why.**
- Q2: Do you agree with the approach proposed in paragraphs 18-20 of the draft guidelines on how to take the products' nature into account? If not, please explain what changes should be made and why.**
- Q3: Do you agree with the proposed method for the identification of the target market by the distributor?**
- Q4: Do you agree with the suggested approach on hedging and portfolio diversification aspects? If not, please explain what changes should be made and why.**
- Q5: Do you believe further guidance is needed on how distributors should apply product governance requirements for products manufactured by entities falling outside the scope of MiFID II?**
- Q6: Do you agree with the proposed approach for the identification of the 'negative' target market?**
- Q7: Do you agree with this treatment of professional clients and eligible counterparties in the wholesale market?**
- Q8: Do you have any further comment or input on the draft guidelines?**
- Q9: What level of resources (financial and other) would be required to implement and comply with the Guidelines (market researches, organisational, IT costs, training costs, staff costs, etc., differentiated between one off and ongoing costs)? If possible please specify the respective costs/resources separately for the assessment of suitability and related policies and procedures, the implementation of a diversity policy and the guidelines regarding induction and training. When answering this question, please also provide information about the size, internal organisation and the nature, scale and complexity of the activities of your institution, where relevant.**

3.2 Annex 2 – Cost-benefit analysis

Background

1. In order to strengthen the level of investor protection across the Union and to reinforce the confidence in financial markets, MiFID II introduced new requirements to ensure that firms act, throughout the entire life cycle of their products and services, in accordance with the best interests of their clients. The new product governance requirements are established under Articles 16(3) and 24(2) of MiFID II and further detailed under Article 9 of MiFID II Delegated Directive, for manufacturers, and under Article 10 of MiFID II Delegated Directive, for distributors. The rules aim to avoid and reduce from an early stage any potential risks of failure to comply with investor protection rules. In particular, firms that manufacture financial products should specify, as part of the product approval process, a target market of end clients for whose needs, characteristics and objectives the product is intended as well as a distribution strategy which is consistent with the identified target market. These firms should then make available to any distributor information on the product approval process, including the target market and distribution strategy. Furthermore, distributors are required to understand the features of the financial instruments they offer or recommend and, using the information obtained from manufacturers and information on their own clients, identify a target market of clients to whom products and services are intended to be provided.
2. MiFID II product governance framework states that the rules may be applied in a proportionate manner, taking into account the nature of the instrument, the investment service and the target market for the product¹¹. In particular, the level of granularity of the target market and the criteria used to define the target market and determine the appropriate distribution strategy should be relevant for the product and should make it possible to assess which clients fall within the target market as well as, for example, to assist the ongoing reviews after the financial instrument is launched¹².
3. These draft Guidelines mainly address the target market assessment since this aspect is considered the most important for ensuring a common, uniform and consistent as well as timely implementation of the MiFID II requirements related to the product governance.
4. They also aim to establish a coherent and effective approach in the supervision of firms subject to these guidelines by National Competent Authorities which will contribute to the enhancement of customer protection across Member States. The guidelines will therefore help to clarify the expected standard of conduct and organisational arrangements for those firms engaged in the manufacturing and distribution of products in order to mitigate any consumer detriment from the early stages of a product's life cycle.

¹¹ MiFID II Delegated Directive, Article 9(1), for manufacturers and Article 10(1), for distributors.

¹² MiFID II Delegated Directive, Recital (19), which clarifies that for simpler, more common products, the target market could be identified with less detail while for more complicated products such as bail-inable instruments or less common products, the target market should be identified with more detail.

The impact of ESMA guidelines

5. In light of the main focus of these draft Guidelines, the following preliminary assessment will consider the benefits and costs of the key policy choices that are presented for consultation in relation to the assessment of the target market by manufacturers and distributors of relevant services and products.
6. Since the requirements on product governance have already been set out under MiFID II and the relevant Delegated Directive, the impact of the current guidelines should be considered in light of and strictly deriving from those legal provisions which they support. While market participants will likely incur certain costs for implementing these guidelines, they will also benefit from increased legal certainty and a harmonised application of the requirements across Member States. Investors would in turn benefit from an enhanced investor protection framework which aims to ensure that the products and services they are offered or recommended have been designed and distributed with their needs and objectives in mind. Overall, the new product governance framework should make financial markets more secure and improve investor confidence and participation in financial markets.

Benefits

7. These guidelines set out an additional level of detail in the area of product governance for firms and competent authorities providing clarity for the definition of the national rules and supervision. By pursuing the objective of ensuring a consistent and harmonised implementation and application of the new requirements in the area of product governance, the proposed Guidelines will make sure that the objectives of MiFID II and the MiFID II Delegated Directive can be achieved, across Member States, without imposing undue additional burdens on stakeholders.
8. As underlined by the MiFID II co-legislators, the major positive effect should derive from an improved compatibility between investment products and the needs and characteristics of clients which should lead to an increased quality of the services and products offered and sold to investors.
9. The proposed Guidelines – should also facilitate competent authorities' efforts to improve overall compliance with MiFID requirements and deliver on the objectives to increase investor confidence and participation in financial markets which are considered necessary for the establishment of a genuine single capital market.
10. It is possible to illustrate the major benefits linked to the proposed Guidelines as follows:
 - a) reduction of the mis-selling risk and its related financial consequences. This represents a benefit for firms due to the reduction of complaints, costs of appeals and legal expenditure for tribunal cases, lack of reputation, fines, etc.;
 - b) restoration of investors' confidence in financial markets;
 - c) positive effects on the productivity and efficiency of the firms;

- d) reduction of risks linked to regulatory or supervisory arbitrage due to an increased degree of harmonisation and more consistent supervisory convergence;
- e) positive effects from improved harmonisation and standardisation on the costs and the processes of implementation for firms, in particular for those firms operating at a cross-border level (this should lead also to a level-playing field and facilitate cross-border activities);
- f) positive effects from improved harmonisation and standardisation for competent authorities on the costs and activities needed to implement the new supervisory process.

Costs

11. On the costs side, it should be reminded that the importance of the product governance arrangements has already been addressed to competent authorities and firms, even before MiFID II was formally adopted. In particular, in 2013 the three ESAs adopted a Joint Position 2013 (JC-2013-77) on Manufacturers' Product Oversight & Governance Processes on financial institutions' internal product approval process. The Joint Position aimed to enhance consumer protection by strengthening the controls by manufacturers before product launch, thus discouraging products and services that may cause consumer detriment from reaching the market. The principles covered manufacturers' responsibilities in organising processes, functions and strategies aimed at designing, operating and bringing products to the market, and reviewing them over the life of the product.
12. On March 2014, ESMA issued an opinion¹³ with the underlying rationale that sound product governance arrangements are fundamental for investor protection. The Opinion indicated a list of good practices that apply when supervising firms that manufacture or distribute structured retail products. Competent authorities were invited to promote, amongst others, general organisation of product governance arrangements, product design, distribution strategy and target market.
13. Given the issuance of these two instruments, it can be expected that firms have already put in place some arrangements in order to comply with the recalled principles and good practices and that this should reduce the overall costs of implementing these Guidelines.
14. Moreover, it should be noticed that the costs triggered by the proposed Guidelines should not be significant for firms given the fact that they are required to implement the rules on product governance under MiFID II and the MiFID II Delegated Directive. Particularly, potential incremental costs that firms will face when implementing the overall product governance framework (so including but not limited to these draft Guidelines) will be both one-off and ongoing costs, arguably linked to:

¹³ ESMA, Opinion on 'Structured Retail Products – Good practices for product governance arrangements' (ESMA/2014/332).

- a) (direct) costs for product development and market research;
- b) (direct) costs for the documentation of the implemented arrangements and disclosure of product information;
- c) (direct) costs to arrange the exchange of information or the agreement between the manufacturer and distributor;
- d) (direct) relevant organisational and HR costs (new activities for the compliance function; costs for the training of sales staff and resources at management level);
- e) (direct) IT costs.

15. ESMA believes that the proposed options in this area provide the most cost-efficient solution to achieving the general objectives of these Guidelines.

Conclusion

16. Therefore, it is possible to consider that the overall costs associated with complying with these Guidelines will determine a higher degree of harmonisation in the implementation and supervision of the product governance requirements which will strengthen investor protection and reduce client detriment. ESMA also considers that the proposed Guidelines are able to achieve an increased level of harmonisation in the interpretation and application of the product governance requirements across Member States, minimising the potential adverse impact on firms linked to compliance costs. These benefits will outweigh all associated costs in respect of these Guidelines.

17. Finally, the adoption of Guidelines is deemed the best tool since – if compared for instance with the issuance of a set of Q&As – it allows for a public consultation and reduces the risk of diverging interpretations that might lead to discrepancies in the application and supervision of the relevant regulation and requirements across Member States (determining a risk of regulatory arbitrage and circumvention of rules).

Q9: What level of resources (financial and other) would be required to implement and comply with the Guidelines (market researches, organisational, IT costs, training costs, staff costs, etc., differentiated between one off and ongoing costs)? When answering this question, please also provide information about the size, internal organisation and the nature, scale and complexity of the activities of your institution, where relevant.



3.3 Annex 3 – Draft guidelines

I. Scope

Who?

1. These guidelines apply to:

- firms subject to any of the following requirements:
 - i. Article 9(3) of Directive 2014/65/EU of the European Parliament and of the Council¹⁴ (MiFID II);
 - ii. Article 16(3) of Directive 2014/65/EU of MiFID II;
 - iii. paragraphs (1) and (2) of Article 24 of MiFID II;
 - iv. Articles 9 and 10 of the Commission Delegated Directive (EU) (MiFID II Delegated Directive).
- competent authorities with supervisory oversight of the above firms.

What?

2. These guidelines apply in relation to the requirements referred to in paragraph 1 of these guidelines; in particular, they concern the manufacturing or distribution of financial instruments or structured deposits.

When?

3. These guidelines apply from 3 January 2018.

II. Purpose

4. The purpose of these guidelines is to provide more clarity on the obligations for firms set out in paragraph 1.
5. ESMA expects these guidelines to promote greater convergence in the implementation and application of the MiFID II requirements on product governance. In complying with these guidelines, ESMA anticipates a corresponding strengthening of investor protection. Annex 4 includes a number of illustrative examples of how a firm might apply the guidelines.

¹⁴ Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (OJ L 173, 12.06.2014, p. 349).

These examples do not form part of the guidelines but instead aim to assist firms in understanding how the requirements in the guidelines can be met.

III. Definitions

6. Unless otherwise specified, terms used in MiFID II have the same meaning in these guidelines. In addition, the following definitions apply:
- 'Firms' mean firms subject to the requirements set out in paragraph 1 and include investment firms (as defined in Article 4(1)(1) of MiFID II, including credit institutions when providing investment services as well as investment firms and credit institutions when selling or advising clients in relation to structured deposits, UCITS management companies and external Alternative Investment Fund Managers (AIFMs) when they are providing the investment services of individual portfolio management or non-core services (within the meaning of Article 6(3)(a) and (b) of the UCITS Directive and Article 6(4)(a) and (b) of the AIFMD);
 - 'Investment product' means a financial instrument or a structured deposit;
 - 'Manufacturer' means, in accordance with Recital 15 and Article 9(1) of the MiFID II Delegated Directive, a firm that manufactures an investment product, including the creation, development, issuance or design of that product, including when advising corporate issuers on the launch of a new product;
 - 'Distributor' means, in accordance with Recital 15 and Article 10(1) of the MiFID II Delegated Directive, a firm that offers, recommends or sells an investment product and service to a client.

IV. Compliance and reporting obligations

Status of the guidelines

7. This document contains guidelines issued under Article 16 of the ESMA Regulation. In accordance with Article 16(3) of the ESMA Regulation, competent authorities and financial market participants must make every effort to comply with the guidelines.
8. Competent authorities to whom the guidelines apply should comply by incorporating them into their supervisory practices, including where particular guidelines are directed primarily at financial market participants.

Reporting requirements

9. Competent authorities to which these guidelines apply must notify ESMA whether they comply or intend to comply with the guidelines, stating their reasons for non-compliance where they do not comply or do not intend to comply, within two months of the date of publication of the translated versions by ESMA to [...]@esma.europa.eu. In the absence of a response by this deadline, competent authorities will be considered non-compliant.



10. Firms are not required to report to ESMA whether they comply with these guidelines.

V. Guidelines on the application of Articles 16(3) and 24(2) of MiFID II

V.I General

11. These guidelines should, in accordance with subparagraph 2 of Article 9(1), and subparagraph 1 of Article 10(1) of the MiFID II Delegated Directive, be applied in a way that is appropriate and proportionate, taking into account the nature of the financial instrument, the investment service and the target market of the product.
12. When a firm acts both as the manufacturer and distributor of investment products, the Guidelines set out below apply as relevant, and as long as the firm meets all the applicable manufacturer and distributor obligations.

V.II Guidelines for manufacturers

Identification of the potential target market by the manufacturer: categories to be considered

13. The potential target market identification by manufacturers should not be solely conducted on the basis of quantitative criteria but needs to be based on sufficient qualitative considerations as well. Services for the mass market in particular, may require automation of processes and this automation is usually based on formulas or algorithmic methodologies which process quantitative criteria for products and clients. Such numerical data is usually generated through scoring systems (for example, by using product features like volatility of financial instruments, rating of issuers, etc. or through “conversion” of factual data into numerical systems). With regard to the target market identification, firms should not solely rely on such quantitative criteria but sufficiently balance them with qualitative considerations.
14. Manufacturers should use the list of categories set out in these guidelines as a basis for identifying the target market for their products. The list of the categories is cumulative: each manufacturer should assess the target market at least for each of those categories. In doing so, a manufacturer should at least analyse the relevance of each category for a certain product and then align the depth of the identification in proportion to the type, nature and other features of the product (as described in paragraphs 16-20 of the guidelines). Manufacturers should not leave out one of the six below mentioned categories. Additional categories should be added if the manufacturer regards them as important to define the target market of the product.
15. Manufacturers need to identify a potential target market. As they usually do not have direct client contact, and in accordance with Article 9(9) MiFID II Delegated Directive, this means that their target market identification may be based on their theoretical knowledge and past experience of the product.

16. Manufacturers should use the following list of six categories:

- (a) The type of clients to whom the product is targeted: The firm should specify to which type of client the product is targeted. This specification should at least be made according to the MiFID II client categorisation of “retail client”, “professional client” and/or “eligible counterparty”. The firm may use additional descriptions commonly used in the respective market like “private wealth clients” or “sophisticated clients” to refine the categorisation but should specify the criteria that must be met in order to categorise clients in this way.
- (b) Knowledge and experience: The firm should specify which knowledge the target clients should have about elements such as: the relevant product type, product features and/or knowledge in thematically related areas that help to understand the product. For example, for structured products with complicated return profiles, firms could specify that target investors should have knowledge of how this type of product works and the likely outcomes from the product. Regarding experience, the firm should describe how much practical experience target clients should have with elements such as: relevant product type, relevant product features and/or experience in thematically related areas. The firm could specify, for example, a time period for which clients should already have been active in the financial markets. Knowledge and experience may be dependent on each other in some cases (i.e. an investor with limited or no experience could be a valid target client if they compensate missing experience with extensive knowledge).
- (c) Financial situation with a focus on the ability to bear losses: The firm should specify the amount of losses target clients should be able and willing to afford (for example, from minor losses to total loss) and if there are any additional payment obligations that might exceed the amount invested (for example, a margin call for a CFD). This could also be phrased as a maximum proportion of net investable assets that should be invested.
- (d) Risk tolerance and compatibility of the risk/reward profile of the product with the target market: The firm should specify the general attitude that target clients should have in relation to the risks of investment. Basic risk-attitudes should be categorised (for example, “risk oriented or speculative”, “balanced”, “conservative”) and clearly described. Since different firms in the chain may have different approaches to defining risk, the firm should be explicit about the criteria that must be met in order to categorise a client in this way. Firms should also use the risk indicator stipulated by the PRIIPs Regulation, where applicable, to fulfil this requirement.
- (e) Clients’ Objectives: The firm should specify the investment objectives of target clients, that is the wider financial goals of target clients or the overall strategy they follow when investing. For example, reference could be made to “liquidity supply”, “retirement provision” or to the expected investment horizon (for example, number of years the investment is to be held). Those objectives can be “fine-tuned” by specific clients’ needs that may narrow or broaden the scope of the objectives

- (f) Clients' Needs: In accordance with Article 16(3) and Article 24(2) of MiFID II, which introduce the separate concept of “needs of an identified target market of end clients”, the firm should specify aspects of the investment and expectations of targeted clients. Clients' needs and their specifications may vary from specific to more generic such as: age, country of tax residence, special product features” like “currency protection”, “green investment”, “ethical investment”, etc., as relevant.

17. Depending on the characteristics of the specific product manufactured, the description of one or more of the above categories may result in the identification of a broad group of target clients that could also encompass a more restricted group. For example, if a product is considered compatible with target clients possessing general relevant knowledge and experience, it will all the more be compatible with a sophisticated level of knowledge and experience.

Identification of the potential target market: differentiation on the basis of the nature of the product manufactured

18. The identification of the target market assessment should be done in an appropriate and proportionate manner, considering the nature of the investment product. This means that the target market identification should consider the characteristics of the products including complexity (including costs and charges structure), risk-reward profile or liquidity, or the innovative character of the product.

19. However, in all cases, the target market must be identified at a sufficiently granular level to avoid the inclusion of any groups of investors for whose needs, characteristics and objectives the product is not compatible.

20. For bespoke or tailor-made products, the target market of the product will usually be the client who ordered the product unless the distribution of the product to other clients is also foreseen.

Articulation between the distribution strategy of the manufacturer and its definition of the target market

21. According to Article 16(3) of MiFID II, the manufacturer shall ensure that its intended distribution strategy is consistent with the identified target and according to Article 24(2) of MiFID II, the manufacturer needs to take reasonable steps to ensure that the financial product is distributed to the identified target market. The manufacturer should define its distribution strategy so that this strategy favours the sale of each product to the target market of this product. This includes that, when the manufacturer can choose the distributors of its products, the manufacturer makes its best efforts to select distributors whose type of clients and services offered are compatible with the target market of the product.

22. In defining the distribution strategy, a manufacturer should determine the extent of clients' information necessary to the distributor to properly assess the target market for its product. Hence, the manufacturer should propose the type of investment service through which the

targeted clients should or could acquire the financial instrument. If the product is deemed appropriate for a sale without advice, the firm should also specify the preferred acquisition channel (face-to-face, via telephone, online) and the specific design of the acquisition channel, if relevant.

V.III Guidelines for distributors

Timing and relationship of target market assessment of the distributor with other product governance processes

23. The distributor's target market identification should be conducted as part of the general decision making process about the range of services and products the distributor is going to distribute. Hence, the target market identification should occur at an early stage, when the firm's business policies and distribution strategies are defined by the management body, on an *ex-ante* basis and before going into daily business.
24. In particular, distributors should take responsibility to ensure, from the very beginning, the general consistency of the products that are going to be offered and the related services that will be provided with the needs, characteristics and objectives of target clients.
25. The decision making process about the service and product universe in combination with the target market identification process should directly influence the way in which the firm's daily business is conducted, as the management body's choices are implemented along the firm's decision chain and hierarchy. Those processes will jointly have a direct impact on the compatibility of products and services offered and will influence all other relevant processes connected with the services provided, especially the definition of budgeting objectives and staff remuneration policies.
26. Firms should especially focus on the investment services through which the products will be offered to their respective target markets. In this context, it is expected that the nature of the products is duly taken into account, paying particular attention to those products characterised by complexity/risk features or by other relevant features (such as, for example, illiquidity and innovation).¹⁵ For example, if a distributor has detailed information on some clients (for example, through an existing relationship with them for the provision of investment advice), it could decide that, considering the particular risk-reward profile of a product, the interest of this group of clients would be best served if execution services are excluded for them. Similarly, the distributor could decide that some non-complex products which could potentially be offered under the execution-only regime will only be

¹⁵ This is in line with Recital 18 of the MiFID II Delegated Directive, which clarifies: '*in light of the requirements set out in Directive 2014/65/EU and in the interest of investor protection, product governance rules should apply to all products sold on primary and secondary markets, irrespective of the type of product or service provided and of the requirements applicable at point of sale. However, those rules may be applied in a proportionate manner, depending on the complexity of the product and the degree to which publicly available information can be obtained, taking into account the nature of the instrument, the investment service and the target market. Proportionality means that these rules could be relatively simple for certain simple, products distributed on an execution-only basis where such products would be compatible with the needs and characteristics of the mass retail market*'

offered in accordance with appropriateness or suitability requirements, so as to grant a higher degree of protection to clients.

27. Specifically, distributors should decide which products are going to be recommended (also through the provision of portfolio management) or offered or actively marketed to certain groups of clients (characterised by common features in terms of knowledge, experience, financial situation, etc.). Distributors should also decide which products will be made available to clients at their own initiative through execution services without active marketing, considering that in such situations the level of client information available may be very limited.
28. In any case, where on the basis of all information and data that may be at the distributors' disposal and gathered through investment or ancillary services or through other sources, including the information obtained from manufacturers, the distributor assesses that a certain product will never be compatible with the needs and characteristics of its current or prospective clients, it should refrain from including the product in its product assortment.

Relation between the product governance requirements and the assessment of suitability or appropriateness

29. The obligation of the distributor to identify the actual target market and to ensure that a product is distributed in accordance with the actual target market is not substituted by an assessment of suitability or appropriateness and has to be conducted in addition to, and before such an assessment. In particular, the identification, for a given product, of its target market and related distribution strategy should ensure that the product ends up with the type of customers for whose needs and objectives it had been designed, instead of another group of clients with which the product may not be compatible.

Identification of the target market by the distributor: categories to be considered

30. Distributors should use the same list of categories used by manufacturers (see paragraph 16), as a basis for defining the target market for their products. However, distributors should define the target market on a more concrete level and should take into account the type of clients they provide investment services to, the nature of the financial instrument and the type of investment services they provide.
31. As the manufacturer has to specify the potential target market based on its theoretical knowledge and past experience with a similar product, it will determine the product's target market without specific knowledge of individual clients. Therefore, its assessment will be conducted with a more general view of how the features/nature of the product would be compatible for certain types of investors, considering their knowledge of the financial markets and their past experiences with similar products and investors. In this way, a set of boundaries is introduced on a more abstract level.
32. The distributor on the other hand has to specify the actual target market, considering the boundaries of the potential target market set by the manufacturer. Distributors should base their target market on their information and their knowledge of their own client base and

the information received from the manufacturer (if any) or information that has been obtained by the distributor itself via desk research (especially in cases where the distributor is a new firm that does not yet have enough actual information about clients at its disposal). Distributors should use the manufacturer's more general target market assessment together with existing information on their clients to identify their own target market for a product that is the group of clients to whom they are effectively going to offer the product through the provision of their services.

33. To this end, distributors should conduct a thorough analysis of the characteristics of their client base, i.e. current/existing clients, as well as potential clients who have a high likelihood of becoming clients (for example, clients with bank deposits to whom they intend to offer investment services). Distributors should use any information and data deemed reasonably useful and available for this purpose that may be at the distributors' disposal and gathered through investment or ancillary services. In addition, they could use any information and data deemed reasonably useful and available for this purpose that may be at the distributors' disposal and gathered through sources other than the provision of investment or ancillary services.
34. Hence, distributors may not just rely on the manufacturer's target market without applying the appropriate scrutiny of how the target market defined by the manufacturer would fit to their client base.
35. It is regarded as good practice for distributors to generally respect the target market as identified by the manufacturer and not to deviate from the fundamental decisions made therein. When distributors define their product assortment, they should pay particular attention to situations where they might not be able to make a thorough target market assessment by virtue of the type of services they provide (in particular, execution services under the appropriateness test or the execution-only regime). This is especially important for products characterised by complexity/risk features (or other relevant features such as, for example, illiquidity or innovation), as well as for situations where there might be significant conflicts of interest (such as in relation to products issued by the firm itself or by other entities within the group). In such circumstances, it is most important that distributors take into due consideration all relevant information provided by the product manufacturer, both in terms of target market and distribution strategy.

Identification of the target market: differentiation on the basis of the nature of the product distributed

36. The identification of the target market assessment by the distributor should also be done in an appropriate and proportionate manner, considering the nature of the investment product, in line with what described in paragraphs 18 to 20.

Identification and assessment of the target market by the distributor: interaction with investment services

37. As noted above, distributors are required to identify and assess the circumstances and needs of the group of clients to whom they are effectively going to offer or recommend a

product (i.e. the ‘actual’ target market for that product), so as to ensure the compatibility between that product and the respective target clients. This obligation should apply in a proportionate manner depending, not only on the nature of the product (see guideline above), but also on the type of investment services that firms provide.

38. In this regard, it should be noted that, on one hand, the *ex-ante* assessment of the actual target market is influenced by the services provided, since it can be conducted more or less thoroughly depending on the level of client information available, which in turn depends on the type of services provided and the conduct of rules attached to their provision (in particular, investment advice and portfolio management allow for the acquisition of a wider set of information on clients compared to the other services). On the other hand, the target market assessment influences the decision on the type of services that are going to be provided in relation to the nature of the product and the circumstances and needs of the identified target clients, considering that the level of investor protection varies for different investment services, depending on the rules that apply at the point of sale. In particular, investment advice and portfolio management services allow for a higher degree of investor protection (through the application of the suitability rule), compared to other services provided under the appropriateness regime or under execution-only.
39. It is therefore expected that when distributors define their product assortment (i.e. the products that will be offered, to whom, and through the provision of which investment services), they pay particular attention to situations where they might not be able to conduct a thorough target market assessment by virtue of the type of services they provide. In particular, where firms only carry out execution services with the assessment of appropriateness (for example through a brokerage platform), they should consider that they will usually be able to conduct an assessment of the actual target market, limited to the sole categories of knowledge and experience of clients; where they only conduct execution services under the execution-only regime, not even the assessment of clients’ knowledge and competence will usually be possible.¹⁶ In this respect, firms should take into due consideration the distribution strategy suggested by the manufacturer (see paragraphs 22, 44 to 46).
40. This is especially relevant for products characterised by complexity/risk features (or other relevant features such as, for example, innovation), as well as for situations where there might be significant conflicts of interest (such as in relation to products issued by entities within the firm’s group or when distributors receive inducements from third parties), being also mindful of the limited level of protection afforded to clients at the point of sale by the appropriateness test (or no protection at all, in the case of execution-only). In such circumstances, it is most important that distributors take into due consideration all relevant information provided by the product manufacturer, both in terms of potential target market and distribution strategy. For example, where the manufacturer’s target market describes a product with particular features which requires, not only detailed client’s knowledge and

¹⁶ As explained above (see guideline xxx), for the definition of the target market, in addition to information gathered through investment or ancillary services, distributors could use any further information and data deemed reasonably useful that may be at their disposal and gathered through other sources. Therefore, even firms only providing investment services under appropriateness or execution-only regime, could be in the position to conduct a more thorough assessment of the target market.

experience, but also a specific financial situation as well as unique objectives/needs, the distributor may decide to adopt a prudent approach by not including it in its product assortment (even though the firm would be in the position to assess *ex-ante* the compatibility of that product with its client base in terms of knowledge and experience).

41. For less complex, more mainstream products distributed under the appropriateness regime, based on the information provided by the manufacturer, there may not be a need for the distributor's thorough target market assessment. For firms only operating under execution-only, Recital 18 of the MiFID II Delegated Directive further clarifies that certain simple products '*would be compatible with the needs and characteristics of mass retail market*'.¹⁷
42. Moreover, taking into account that the client's protection decreases when information available is not sufficient to ensure a full target market assessment, distributors may also decide to let clients operate on a non-advised basis after having warned them that the firm is not in the position to assess their full compatibility with such products.
43. On the contrary, if distributors intend to approach clients or potential clients in any way, to recommend or actively market a product or consider that product for the provision of portfolio management, it is expected that a thorough assessment of the target market is always conducted.

Distribution strategy of the distributor

44. The distributor has to take the distribution strategy of the manufacturer into account and review it with a critical look. Ultimately, including the cases where a manufacturer is an entity not subject to MiFID II and thus it is not obliged to identify a distribution strategy, the distributor has to define its own distribution strategy in light of information on its client base and type of services provided.
45. In particular, while taking into due consideration the suggested distribution strategy of the manufacturer, the distributor could decide to follow a more prudent approach by providing investment services that afford a higher level of protection to investors, such as investment advice. For instance, if the manufacturer considers that the features of a given product are compatible with a distribution strategy through non-advised services, the distributor may still decide that the characteristics of its clients (for example, very limited knowledge and no experience with investments in that type of product, unstable financial situation and very short-term objectives) are such that investment advice would be the most appropriate choice to ensure that their best interests are taken into consideration.
46. On the contrary, the distributor could decide, in certain circumstances, to take a less prudent approach in relation to the distribution strategy defined by the manufacturer. For example, if the manufacturer deems that a given product, due to its specific features,

¹⁷ In this regard, it should also be taken into account that the perimeter of products that can be offered under the execution-only regime is limited to 'non-complex' instruments which are defined under Article 25 (4) of MiFID II, and further detailed by ESMA Guidelines on complex debt instruments and structured deposits.

should be offered to clients through the provision of investment advice, the distributor could still make that product available through execution services to a specific segment of clients. In these situations, it is expected that the distributor would do so only after a thorough analysis of the features of the products and of the target clients. Moreover, this decision should be reported to the manufacturer as part of the distributor's obligation to provide the manufacturer with sales information in a way that the manufacturer can take it into account in their product governance process and when selecting suitable distributors (as described in paragraphs 21-22).

Regular review by the manufacturer and distributor to respectively assess whether products and services are reaching the target market

47. MiFID II¹⁸ require firms to review products on a regular basis to assess whether the product remains consistent with the needs, characteristics and objectives of the identified target market and whether the intended distribution strategy remains appropriate. The same requirements apply to distributors in relation to services offered.
48. Manufacturers should consider, on a proportionate basis, what information they need in order to complete their review and how to gather that information. In line with recital 20 MiFID II Delegated Directive, relevant information could include, for example, information on which distribution channels have been employed, the proportion of sales made outside the target market, summary information of the types of client, a summary of any complaints received and questions suggested by the manufacturer to a sample of clients for feedback. Such information may be in an aggregated form and does not need to be on an instrument-by-instrument or sales-by-sales basis.
49. To support reviews by MiFID manufacturers, distributors must provide them with information on sales and, where appropriate, any other relevant information that may be the outcome of the distributor's own periodic review. Furthermore, distributors should consider data and information that may give an indication that they have wrongly identified the target market for a specific product or service or that the product or service no longer meets the circumstances of the identified target market, such as where the product becomes illiquid or very volatile due to market changes.
50. In relation to the obligation on distributors to report information on sales outside the manufacturer's target market, distributors should be able to report any decisions they have taken to broaden the target market or the distribution strategy from the ones recommended by the manufacturer and information on sales made outside the target market/distribution strategy (including sales within the negative target market).

Distribution of products manufactured by entities not subject to MiFID II product governance requirements

51. Firms that distribute products that have not been manufactured by entities subject to the MiFID II product governance requirements are expected to perform the necessary due

¹⁸ Article 16(3) MiFID II and Articles 9 and 10 of the MiFID II Delegated Directive.

diligence so as to provide an appropriate level of service and security to their clients compared to a situation where the product had been designed in accordance with the MiFID II product governance requirements.

52. Where a product has not been designed in accordance with the MiFID II product governance requirements (for example, in the case of investment products issued by entities that are not subject to the MiFID II product governance requirements), this may affect the information gathering process or the target market identification:

- Target market definition: The distributor shall determine the target market also when the target market is not defined by the manufacturer,¹⁹ according to the principles stated in the paragraphs 13-17. Therefore, even where the firm does not receive a description of the target market from the manufacturer or information on the product approval process, it has to define its “own” target market. This should be done in an appropriate and proportionate manner according to paragraph 36.
- Information gathering process: when a product has not been designed in accordance with the MiFID II product governance requirements, distributors shall take all reasonable steps to ensure that the level of product information obtained from the manufacturer is of a reliable and adequate standard, to ensure that products will be distributed in accordance with the characteristics, objectives and needs of the target market. Where all relevant information is not publicly available (for example, through the PRIIPs KID or a prospectus), the reasonable steps should include entering into an agreement with the manufacturer or its agent in order to obtain all relevant information enabling the distributor to carry out its target market assessment. Publicly available information may only be accepted if it is clear, reliable and produced to meet regulatory requirements²⁰. For example, information disclosed in compliance with requirements in the Prospectus Directive, the Transparency Directive, the UCITS Directive or the AIFMD Directive may be acceptable.

53. This obligation is relevant for products sold on primary and secondary markets and shall apply in a proportionate manner, depending on the degree to which publicly available information is available and the complexity of the product²¹.

54. Where the distributor is not in the position to obtain in any way sufficient information on products manufactured by entities not subject to the MiFID II product governance requirements, the firm would be unable to meet its obligations under MiFID II and, consequently, should refrain from including them in its product assortment.

Application of product governance requirements to the distribution of products that were manufactured before the entry into force of MIFID II.

¹⁹ See Article 10(1) of the MiFID II Delegated Directive.

²⁰ See Article 10(2) of the MiFID II Delegated Directive.

²¹ See subparagraph 3 of Article 10(2) of the MiFID II Delegated Directive.

55. Products manufactured and distributed before 3 January 2018 should not fall within the scope of the product governance requirements as defined by MiFID II.
56. Products which have been manufactured before 3 January 2018 but which are distributed to investors after 3 January 2018 should fall within the scope of product governance requirements applicable to distributors, in particular, the requirement to identify a target market for any financial product. In this situation, the distributor should act as if the manufacturer was an entity not subject to MiFID II product governance requirements.
57. However, a target market should be assigned by the manufacturer to such products, at the latest, following the next product review process cycle that is conducted according to Article 16(3) after 3 January 2018. The distributor should then consider this target market in its own review process.

V.IV Guidelines on issues applicable to both manufacturers and distributors

Identification of the ‘negative’ target market and sales outside the positive target market

58. The firm needs to consider whether the product would be incompatible with certain target clients (“negative” target market). When doing so, the firm should apply the same categories and principles as stated above in paragraphs 13-17 and 30-35. In line with the approach followed for the identification of the ‘positive’ target market, the manufacturer, who does not have a direct relationship with end-clients, will be able to identify the negative target market on a theoretical basis, i.e. with a more general view on how the specificities of a given product would not be compatible with certain groups of investors; the distributor, taking into account the manufacturer’s more general negative target market as well as information on its own client base, will be in the position to identify more concretely the group of clients to whom it should not distribute that specific product. In addition, the distributor is also required to identify any group(s) of clients for whose needs, characteristics and objectives, a service related to the distribution of a certain product would not be compatible.
59. Some of the target market characteristics used in the positive target market assessment by manufacturers and distributors will automatically lead to opposing characteristics for investors for whom the product is not compatible (for example, if a product is made for the investment objective “speculation” it will at the same time not be suitable for “low risk” objectives). In this case, a firm could define the negative target market by stating that the product or service is incompatible for any client outside the positive target market.
60. Again, it is important to take account of the principle of proportionality. When assessing a potential negative target market, the number and detail of factors and criteria will depend on the nature, especially the complexity or the risk-reward profile, of the product (i.e. a plain vanilla product is likely to have a smaller group of possible investors for whom it is incompatible, while the group of clients for whom the financial instrument is not compatible might be large for a complicated product).

61. There might be situations where products could, under certain circumstances and where all other legal requirements are met (including those relating to disclosure, suitability or appropriateness, identification and management of conflicts of interest), be sold outside the positive target market. However, these instances should be justified by the individual facts of the case, they should not occur on a regular basis and the reason for the deviation should be clearly documented and, where provided, included in the suitability report.
62. As the negative target market is an explicit indication of those clients for whose needs, characteristics and objectives the product is not compatible and to whom the product should not be distributed, the sale to investors within this group should be a rare occurrence, the justification for the deviation should be accordingly significant and is generally expected to be more substantiated than a justification for a sale outside the positive target market.
63. For example, the sale of products outside the target market could occur as a result of non-advised sales (i.e. where clients approach a firm to purchase a certain product without any active marketing by the firm or having been influenced in any way by that firm), where the firm does not have all the necessary information to conduct a thorough assessment of whether the client falls within the target market, which might be the case, for instance, for execution platforms that only operate under the appropriateness regime. It is expected that in the context of product governance arrangements, firms analyse ex-ante situations such as the one described, and make a responsible decision on how they are going to address them should they occur, and that client-facing employees are informed of the approach defined at management body level, so that they can comply with it. Firms should also take into consideration the nature of the products included in the range of those they intend to offer to clients (for example, in terms of complexity/risk) and the existence of any conflicts of interest with clients (such as in the case of self-placement), as well as their business model. Some firms could, for example, consider the possibility of not allowing clients to operate if they fall within the negative target market, while letting other clients transact on a financial product which is in the 'grey' area, i.e. between the positive and negative target markets.
64. It is important that if the distributor becomes aware, for example, through the analysis of clients' complaints or other sources and data, of the fact that the sale of a certain product outside the target market identified ex-ante has become a significant phenomenon (for instance, in terms of number of clients involved), such input is taken into due consideration in the course of its periodic review of the products and related services offered. In such cases, the distributor may, for example, come to the conclusion that the target market originally identified was not correct and that it needs to be reviewed or that the related distribution strategy was not appropriate for the product and has to be reconsidered.
65. Deviations from the target market (outside the positive or within the negative) which may be relevant for the product governance process of the manufacturer (especially those which are recurrent) should be reported to the manufacturer.

Application of the target market requirements to firms dealing in wholesale markets (i.e. with professional clients and eligible counterparties)

Professional clients and eligible counterparties as part of the intermediation chain

66. The requirements set out in Article 16(3) MiFID II apply irrespective of the nature of the client (retail, professional or eligible counterparty). At the same time Article 16(3) and 24(2) MiFID II specifies that the clients to be targeted shall be the “end-clients”. This means that a firm does not need to specify a target market for other firms (professional clients and eligible counterparties) within the intermediation chain, but rather it needs to design the target market with the end-client in mind (i.e. the final client in the intermediation chain). The specific type of end-client targeted is to be stated in the above-mentioned client-type category.
67. Where a professional client or an eligible counterparty buys a product with the intention to sell it on to other clients, therefore acting as a link in the intermediation chain, they should not be considered as “end-clients”.
68. In such a case, the professional client (or eligible counterparty) would be acting as distributor and therefore should comply with the product governance requirements applicable to distributors.
69. For example, if a firm sells a product to an eligible counterparty that buys the product with the intention of distributing it more widely to professional or retail clients, the eligible counterparty must reassess the relevant target market in line with its obligations as a distributor. If the eligible counterparty then makes changes to the product before onward distribution, this is likely to mean that it must comply with the product governance provisions for manufacturers as well as those for distributors.

Professional clients and eligible counterparties as end-clients

70. The MiFID client categorisation framework calibrates conduct of business protections to the needs of each client category (i.e. retail clients, professional clients and eligible counterparties). In a wholesale market context (which includes professional clients and eligible counterparties only), MiFID allows certain assumptions to be made about clients’ knowledge and experience with respect to understanding investment risks.
71. MiFID II requires firms to ensure that the products they manufacture and/or distribute are designed to meet the needs of an identified target market of end-clients within the relevant category of clients. As such, when assessing the appropriate target market for a particular product, firms should consider the appropriate client category and whether it allows them to make any assumptions about the end clients’ knowledge and experience.

For professional clients as end-clients

72. Firms are entitled to assume that professional clients have the required knowledge and experience to understand the risks attached to the particular products or services for which they have been classified as a professional client. MiFID nonetheless, makes a distinction between per se professional clients and elective professional clients – providing that clients

in the latter category should not be presumed to possess the knowledge and experience comparable to per se professional clients.

73. Therefore, firms should, when carrying out their target market identification, consider the differences in assumed knowledge between retail and professional clients and, within the professional client category, elective professional clients and per se professional clients. For example, the contrast in approach should take account of the differences in the knowledge and experience profiles of these different client categories.
74. It is possible that some products (for example those which are suitable for distribution in mass retail markets) will have a widely defined target market which might include both retail and professional clients. Such products, for example, units or shares in an ordinary UCITS fund, could, by default, be regarded as having a target market that includes professional clients. However, some other products, in particular products which have complex risk profiles, will have a more narrowly defined target market. For instance, the target market for a contingent convertible bond might be only composed of per se professional or elective professional clients who are likely to understand the complexities associated with these products.

For eligible counterparties as end-clients

75. MiFID recognises eligible counterparties as the most sophisticated class of investors and capital market participants, consequently switching off many of the conduct of business protections in respect of these clients. MiFID II however, seeks to increase the protections afforded to non-retail clients, extending certain information and reporting requirements to firms' dealings with eligible counterparties. While firms are not obliged to apply the requirements in Article 24 (with the exception of paragraphs 4 and 5) of MiFID II when entering into transactions with eligible counterparties (Article 30(1) of MiFID II), they will still need to ensure that they act "honestly, fairly and professionally" and communicate in a way that is "fair, clear and not misleading" in their dealings with eligible counterparties. Furthermore, the requirements set out in Article 16(3) of MiFID II apply irrespectively of the nature of the client (retail, professional or eligible counterparties).
76. Where the target market of end-clients is composed solely of eligible counterparties, the overall assessment is likely to be less comprehensive. Eligible counterparties will be likely to have a detailed understanding of the market environment, commercial viability and other key factors and risks associated with a particular investment decision.

4 Annex 4 - Illustrative examples and case studies related to the application of certain aspects of the guidelines

Case studies

Case study 1 - Structured investment product

Product

A six-year term product linked to the performance of shares of three blue-chip companies (one bank, one oil company and one technology stock).

At the end of the term, if all three shares are priced at above the initial value, the product aims to repay the investor's initial capital plus the average capital return of the three shares.

If one or more of the shares has fallen below the initial value by the end of the term (but not by more than 50%), the product aims to return the initial capital at the end of the term.

After six years, if the final price of any of the three shares is below 50% of its initial value, the investor suffers capital loss in line with the worst performing company.

The underlying components (the derivatives and fixed interest securities) are issued by the same investment bank, which has a low investment-grade credit rating.

The product has a legal structure of notes issued by an unlisted special purpose vehicle based outside the EEA but is packaged by an EU-based regulated firm. A prospectus is issued in accordance with the Prospectus Directive.

Target market

1. Type of client: eligible counterparties, professional clients, and sufficiently experienced and knowledgeable retail clients (see below)
2. Investor knowledge and experience:
 - experience with direct investment in structured products
 - understanding of what factors drive the movement of share prices and of how the movement of share prices impacts the value of the product
 - ability to understand the benefits of diversification and limited downside protection
 - understanding of counterparty risk and the credit rating of the bank that issued the underlying components, including any added risks arising from firms in different jurisdictions working together, and

- understanding of the main assumptions behind the investment proposition, including the scenario analysis performed by the manufacturer
- 3. Investor's financial situation: ability to tie money up for six years and to bear a 100% capital loss
- 4. Risk tolerance and compatibility of the risk/reward profile of the product with the target market:
 - financial ability and willingness to put the entire capital invested at risk, and
 - willingness to forego the benefits of diversification in exchange for limited downside protection
- 5. Client objectives: looking for the possibility of capital growth only over the medium-term
- 6. Client needs: six-year term investment horizon, and expectation that, at expiry, none of the stocks will be worth less than 50% of the initial valuation.
- 7. Clients who should not invest (the 'negative target market'): clients lacking the requisite knowledge and experience and/or the ability to tolerate the risks of the investment are deemed incompatible with the characteristics of this product.
- 8. Distribution channel: In light of the target market analysis, the optimal retail distribution channel for the product is via advised sales only. This will allow evaluation of whether the client fits into the target market. Where clients are classified as professional clients or eligible counterparties for this type of products, they may be assumed to have the relevant knowledge or experience to make their own investment decisions without advice.

Case study 2 - Structured deposit product target market case study

Product

A six-year term product linked to the performance of the main share index of the Member State of the issuing firm.

At the end of the term, if the index is at 100% or more than its initial level, the plan aims to provide a return at maturity of the initial investment plus 15%.

If the index has fallen below the initial value by the end of the term, the product aims to return the initial capital at the end of the term.

The product has the legal structure of a structured deposit issued by a bank. Each investor holds a deposit account.

Target market



1. Type of client: eligible counterparties, professional clients, and all retail clients
2. Investor knowledge and experience:
 - some knowledge or experience of the share index and the index mechanics
 - understanding of the possibility of inflation eroding value if the stock market falls over the investment term,
 - understanding of the risk/reward profile of the product compared to currently-available term deposit accounts of the same duration and tracker fund, and
 - understanding of the main assumptions behind the investment proposition, including the scenario analysis performed by the manufacturer
 - understanding the most likely pay-off at maturity
3. Investor's financial situation:
 - ability to tie money up for six years
 - no immediate needs for cash
4. Risk tolerance and compatibility of the risk/reward profile of the product with the target market: willing to accept possibly lower returns in order to seek protection against capital loss
5. Client objectives:
 - looking for possibility of capital growth only
 - looking for the potential of earning a greater return than in a comparable deposit account
6. Client needs:
 - six-year term investment horizon, and
 - recourse to the Deposit Guarantee Scheme in the event that the issuer fails
7. Clients who should not invest (the 'negative-target market'): this product is deemed incompatible for clients which:
 - need early access to the capital
 - are unwilling to accept the possibility of inflation eroding value, if the stock market falls over the investment term, or



- would have their savings objectives materially affected if they only receive back the original capital amount

8. Distribution channel:

- In light of the target market analysis, the product can be promoted with or without advice, with no additional requirements or restrictions on distributors.
- The product should be sold only in the home state to avoid creating complications with cross-border business (for example, involving possible currency movements or complexities in the recourse to the Deposit Guarantee Scheme).
- Where clients are classified as professional clients or eligible counterparties for this type of business, they may be assumed to have the relevant knowledge or experience to make their own investment decisions.

Case-study 3: Target market assessments relevant to distribution in wholesale markets (i.e. to professional clients and eligible counterparties).

Example 1

A firm sells a product to an eligible counterparty; the eligible counterparty buys the product with the stated aim of structuring a packaged product for onward distribution to professional and/or retail clients. In this case, the firm selling the product must ensure that the proper information is provided to the eligible counterparty in respect of the product. The eligible counterparty is also obliged to carry out its own target market assessment in line with its obligations as a distributor.

Furthermore, before onward distribution to professional and/or retail clients, the eligible counterparty will also have to comply with the product governance provisions for manufacturers as well as those for distributors in relation to the new packaged product.

Example 2

This scenario is identical to example 1, except that the firm selling the product to the eligible counterparty is unaware that the eligible counterparty intends to distribute the product more widely to professional and/or retail clients. As such, the eligible counterparty would be considered by the firm as an “end-client” in respect of its target market assessment.

If the eligible counterparty subsequently decides to further distribute the product, it will be responsible for acquiring the relevant information from the firm (i.e. the manufacturer) in order to carry out its own target market assessment. This assessment is likely to be more detailed than the target market assessment initially carried out by the manufacturer which has only eligible counterparties as end-clients. The eligible counterparty should keep communication channels as clear as possible with the firm, ensuring that it acquires all necessary information



for the purposes of carrying out its own target market assessment and that any required information on the product is passed back to the firm (i.e. so that the firm can discharge its own obligations as a manufacturer).

Moreover, as set out in example 1, if the eligible counterparty makes any changes to the product, it will likely need to comply with the product governance provisions for manufacturers as well as those for distributors.