



European Securities and
Markets Authority

Final Report

Guidelines on MiFID II product governance requirements





European Securities and
Markets Authority

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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.

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 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 Guidelines aim at making sure that the objectives of MiFID II and the MiFID II Commission Delegated Directive¹ (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.

On 5 October 2016, ESMA published a Consultation Paper (CP) on the draft guidelines on certain aspects of the MiFID II product governance requirements² in order to explain its rationale and gather input from stakeholders. The consultation period closed on 5 January 2017.

ESMA received 102 responses, 19 of which confidential. The answers received are available on ESMA's website unless respondents requested otherwise. ESMA also sought the advice of the Securities and Markets Stakeholder Group's (SMSG). This paper summarises and analyses the responses to the CP and explains how the responses have been taken into account. ESMA recommends reading this report together with the CP published on 5 October 2016 to have a complete view of the rationale for the guidelines.

Contents

Section 2 contains the overview to the Final Report; Annex I contains the high-level cost-benefit analysis; Annex II contains the Opinion of the SMSG; Annex III contains the feedback statement; Annex IV contains the full text of the final guidelines; Annex V contains some practical examples and case studies related to the application of certain aspects of the guidelines.

Next Steps



The guidelines in Annex IV will be translated into the official EU languages and published on ESMA's website. The publication of the translations in all official languages of the EU will trigger a two-month period during which NCAs must notify ESMA whether they comply or intend to comply with the guidelines.

¹ Commission Delegated Directive 2017/593.

² ESMA/2016/1436.

2 Overview

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 individual 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. These obligations were further specified in Articles 9 and 10 of the 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 offered in the interest of clients.³
2. The objective of the product governance requirements is to ensure that firms, which manufacture and distribute financial instruments and structured deposits (from here on referred to as 'investment products'), 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 or recommend to clients and when offering or recommending such products to clients ('product governance obligations for distributors').
4. Recital 71 of MiFID II specifies 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, also in order to enable the creation of a level-playing field that will facilitate cross-border activities. Furthermore, establishing consistent, efficient and effective supervisory practices on the 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

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*'.



without prejudice to other potential ESMA work on other aspects of the MiFID II product governance requirements.

6. On 5 October 2016 ESMA published a Consultation Paper (CP)⁴ on the draft guidelines on certain aspects of the MiFID II product governance requirements in order to explain its rationale and gather input from stakeholders. The consultation period closed on 5 January 2017.
7. ESMA received 102 responses, 19 of which confidential. The answers received are available on ESMA's website unless respondents requested otherwise.
8. As provided by Article 16(2) of the ESMA Regulation, ESMA also sought the advice of the Securities and Markets Stakeholder Group's (SMSG)⁵. The SMSG's overall view of these guidelines was positive although some focused remarks were raised.⁶
9. Following the analysis of the responses to the consultation and the SMSG advice, ESMA has modified the guidelines in certain instances and provided some further case studies in the annex in order to provide further clarification for the application of the guidelines.
10. In relation to the cost benefit analysis, as stated in the preliminary CBA annexed to the CP, a qualitative assessment of costs and benefits was provided also considering that in many cases both costs and benefits are direct consequences of the application of the new requirements stemming from MiFID II and the MiFID II Delegated Directive. Investment firms will face both one-off and on-going compliance costs. ESMA considers that the costs associated with the new requirements will result in greater standards of services to clients, a higher degree of investor protection and an overall reduction in client detriment. ESMA considers that these benefits will outweigh all associated costs in respect of these guidelines.

⁴ ESMA/2016/1436.

⁵ The SMSG response has been published on the ESMA website at the following address https://www.esma.europa.eu/system/files/force/library/2016-smsg-024_smsg_advice_on_mifid_ii_product_governance_0.pdf

⁶ See Annex II to this Final Report.

3 Annexes

3.1 Annex I - 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 new requirements aim to avoid and reduce from an early stage any potential risks of failure to comply with investor protection rules. In particular, under the new legal framework, firms that manufacture financial products shall 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, including the target market and distribution strategy. Furthermore, distributors are required to understand the features of the investment products they offer or recommend and, using the information obtained from manufacturers and the information on their own clients, identify a target market of clients to whom products and services are intended to be provided.
2. The 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 product⁷. 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 calibrated to 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 review after the investment product is launched⁸.
3. These Guidelines mainly address the target market assessment since this aspect is considered the most important one 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 firms

⁷ MiFID II Delegated Directive, Article 9(1), for manufacturers and Article 10(1), for distributors.

⁸ 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.



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.

The impact of ESMA guidelines

5. In light of the main focus of these Guidelines, ESMA developed a preliminary assessment considering the benefits and costs of the key policy choices presented for consultation in relation to the assessment of the target market by manufacturers and distributors. As already clarified in the preliminary impact analysis annexed to the CP, a qualitative assessment of costs and benefits can be provided also considering that in many cases both costs and benefits are direct consequences of the application of the new requirements stemming from MiFID II and the MiFID II Delegated Directive.
6. Since the new requirements have been set out under MiFID II and the relevant Delegated Directive, the impact of the current guidelines should be considered in light of, those legal provisions that they support. While market participants will likely incur certain costs for implementing these guidelines, they will also benefit from the increased legal certainty and the harmonised application of the requirements across Member States. Investors would in turn benefit from an enhanced degree of protection, which aims to ensure that the products and services they are offered or recommended have been designed and distributed with their objectives and needs in mind. Overall, ESMA believes that 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 for the application of the new rules and the definition of supervisory approaches. By pursuing the objective of ensuring a consistent and harmonised implementation and application of the new requirements in the area of product governance, the Guidelines will make sure that the objectives of MiFID II and 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 main positive effect stemming from the new requirements on product governance should consist in improving the compatibility between investment products and the needs and characteristics of clients and consequently improving the quality of the products offered and sold to investors.
9. The Guidelines should also facilitate competent authorities' efforts to improve overall compliance with the MiFID requirements and to deliver on the objectives of increasing investor confidence and participation in financial markets, which are necessary for the establishment of a genuine single capital market.
10. It is possible to summarise the main benefits linked to the Guidelines as follows:

- a) reduction of the mis-selling risk and its related financial consequences. This represents a benefit not only for investors, but also for firms due to the reduction of complaints, costs of appeals and legal expenditure for tribunal cases, lack of reputation, fines, etc.;
- b) restoring investors' confidence in financial markets;
- c) positive effects on the productivity and efficiency of 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 that will facilitate cross-border activities);
- f) positive effects from improved harmonisation and standardisation for competent authorities of costs and activities needed for the implementation of the new supervisory process.

Costs

11. In its preliminary assessment developed at the time of the publication of the CP, ESMA reminded that the importance of the product governance arrangements has already been emphasised 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 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 opinion⁹ with the underlying rationale that sound product governance arrangements are fundamental for investor protection. The Opinion indicated a list of good practices that should be applied 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 identification.
13. Given the issuance of these two instruments, ESMA underlined the likelihood that firms had already put in place some arrangements in order to comply with the recalled principles

⁹ ESMA, Opinion on 'Structured Retail Products – Good practices for product governance arrangements' (ESMA/2014/332).

and good practices and that this should reduce the overall costs of implementing these Guidelines.

14. Moreover, ESMA noted that the specific costs triggered by the Guidelines should not be significant for firms given the fact that they are required to comply with the new MIFID II rules on product governance. As also emerged from the responses to the CP, the incremental costs that firms will face when implementing the overall product governance framework (including but not limited to these Guidelines) will be both one-off and ongoing costs, arguably linked to the following.

One-off costs

- a) Initial IT investments;
- b) Procedural and organisational arrangements (business, compliance and legal, including distributors' procedures to inform the manufacturers of deviations from the target market and the activities needed to identify the target market for product manufactured by entities non subject to the MiFID II product governance requirements);
- c) Organisational and HR costs (linked to the new activities for the compliance function; costs due to the training of staff and resources needed at management level);
- d) Legal costs, including costs related to the possible development of new "distribution agreements" (particularly relevant in those cases where manufacturers are not subject to MiFID II product governance requirements) and those costs related to the updating of existing agreements;

On-going costs

- a) Running IT costs;
- b) Control and compliance costs;
- c) Costs related to the exchange of information between distributors and manufacturers.

15. ESMA believes that the policy options adopted in this area provide the most cost-efficient solution, taking into consideration the relevant legislative framework, to achieving the general objectives of these Guidelines.

Conclusion

16. Respondents to the consultation noted that it was difficult to estimate the costs stemming from the implementation of the Guidelines. In many cases, respondents acknowledged that the majority of costs will stem directly from the application of the new MiFID requirements rather than the ESMA guidelines.

17. Finally the overall resources associated with these Guidelines will facilitate the achievement of a higher degree of harmonisation in the implementation and supervision of



the product governance requirements, in a way that will strengthen investor protection and reduce client detriment. ESMA also considers that the increased harmonisation in the interpretation and application of the product governance requirements across Member States will minimise the potential adverse impact on firms linked to compliance costs and contribute to facilitate cross-border activities. These benefits will outweigh all associated costs in respect of the Guidelines.



3.2 Annex II - Opinion of the Securities and Markets Stakeholder Group

11. As provided by Article 16(2) of the ESMA Regulation, ESMA also sought the advice of the Securities and Markets Stakeholder Group's (SMSG)¹⁰. The SMSG's overall view of these guidelines was positive and it stated in its advice that the guidelines provide guidance and establish a framework to define the target market for investment products under MiFID II and, in doing so, reduce the risk of miss-selling. Nevertheless, the SMSG had some focused remarks, in relation to (i) the respective role of distributor and manufacturer and the communication between both; (ii) assets which trade on a secondary market; (iii) the application of the guidelines to execution-only and execution under appropriateness; (iv) the dichotomy of product approach versus portfolio approach; (v) the distribution of UCITS and AIFs; and (vi) implementation costs of the guidelines.

¹⁰ The SMSG response has been published on the ESMA website at the following address https://www.esma.europa.eu/system/files_force/library/2016-smsg-024_smsg_advice_on_mifid_ii_product_governance_0.pdf

3.3 Annex III - Feedback on the consultation paper

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.

1. The majority of respondents generally supported the list of six categories included in the draft guidelines and noted that these categories logically stem from the requirements on product governance and suitability/appropriateness included in MiFID II and the MiFID II Delegated Directive.

General comments

2. Several respondents noted that the list of six categories included in the guidelines should be a closed list and no further categories should be added, on a case-by-case basis by individual manufacturers. These respondents noted that the use of further categories would make the exchange of information between manufacturers and distributors more complex considering that the process will need to be IT-based and standardised as much as possible. These respondents suggested that any specific product features could be added as sub-categories to the existing six.
3. The SMSG, in its advice to ESMA, noted that it is important that the concepts used by the manufacturer in identifying the target market are clearly defined. The SMSG acknowledged that establishing a common conceptual framework and common definitions “seems to be an endeavour, which realistically speaking, cannot be achieved on the short term” but suggested that the guidelines state the need for the manufacturer to clearly define the concepts that are being used.
4. ESMA agrees with the comments above and underlines that the purpose of the guidelines is to ensure a harmonised implementation and application of the MiFID II product governance requirements. ESMA believes that the guidelines should have the positive effect of standardising procedures leading to a level-playing field and facilitating exchange of information between manufacturers and distributors. With this in mind, ESMA has amended the guidelines taking into consideration the two suggestions above. Furthermore, ESMA notes that it retains the possibility to do further supervisory convergence work on the topic.
5. A few respondents noted instead that firms should not be required to define a target market for products designed only for distribution outside of the European market. ESMA notes that the requirements set out under Articles 16(3) and 24(2) of MiFID II, and in Article 9 of the MiFID II Delegated Directive apply to all investment products manufactured in the Union, independently of where they are distributed. ESMA therefore believes that no changes to the guidelines are necessary in relation to this specific point.
6. Some of the consumer organisations replying to the consultation noted that none of the six categories addresses the number one issue: ‘toxic investment products’ that fail to deliver even the present value of the amount invested. ESMA agrees with the importance of

addressing the risk of mis-selling of financial products and notes that, as clearly set out in Article 24(2) of MiFID II, financial products need to be designed to meet the needs of end clients and should be offered to clients only when it is in their interest. ESMA therefore believes that firms manufacturing or distributing ‘toxic investment products’ would not be deemed compliant with MiFID II requirements. For this reason, ESMA does not believe that the addition of further categories is needed. On the other hand, ESMA confirms its intention to work closely with national competent authorities to ensure that the product governance requirements are uniformly implemented and applied across all Member States.

Comments on specific categories

7. Several detailed comments were raised by respondents on the individual categories set out in the guidelines. A summary of these comments are set out below.
8. With regard to the category of ‘type of clients to whom the product is targeted’:
 - The majority of respondents noted that, in order to ensure comparability between the systems of the manufacturer and the distributor, the client categories should not go beyond the MiFID categories for client categorisation which is now an industry standard and should be used also for the purpose of the target market definition. These respondents noted that the use of terms not defined by law or not used with the same meaning across the industry would be a source of confusion and uncertainty.
 - Some consumer organisations noted that concepts need to be clearly defined in order to avoid misinterpretations and words as “retail client”, “professional client” or “eligible counterparty” could lead to a misunderstanding if they are not well explained.

ESMA agrees that in order to ensure a consistent and harmonised implementation of the product governance requirements, it is beneficial, when defining the target market of a product, to adhere to the MiFID client categories. Furthermore, ESMA notes that the types of clients suggested in the CP (for example, “private wealth clients”) should instead be captured when dealing with other aspects of the target market. ESMA has therefore updated the guidelines for this category. ESMA however recommends that manufacturers should ensure that all other categories are duly used to refine the target market. Finally, ESMA notes that terms “retail client”, “professional client” or “eligible counterparty” used in the guidelines refer to the terms defined in Article 4 and Annex II of MiFID II.

9. With regard to the category of ‘knowledge and experience’, while the majority of respondents supported the proposal to include this category in the criteria used in the guidelines, various respondents noted that the criterion presents challenges as it is not standardised across industry as each firm uses its own set of client exploration forms for the mapping of clients’ knowledge and experience. These respondents stated that the examples provided in the draft ESMA guidelines included too much detail to be processed by distributors. Respondents suggested:

- a hierarchical approach regarding levels of knowledge and experience (for example: low, medium, and high/specific); or
 - introducing in the guidelines a closed list of criteria to classify clients' experience (for example: no specific knowledge required; equities; forex; credit/bonds; commodities; etc.)
10. Furthermore, respondents from the investment management industry noted that the draft guidelines seem to accommodate only complex products and would not allow simple products, such as non-structured UCITS, to be distributed to “first time” investors that have no prior experience and that could acquire “basic” knowledge of the instrument via the PRIIPs KID and UCITS KIID.
11. As already noted above, the objective of the ESMA guidelines on product governance is to ensure a harmonised application of the new requirements. For this reason, ESMA has included in the guidelines six categories to be used by all manufacturers, when defining the target market. With specific reference to the category of knowledge and competence, ESMA acknowledges that there are different practices used by firms to assess clients' knowledge and competence, but believes that is beyond the scope of these guidelines to set out an industry standard. With regard to how the guidelines should be applied in the case simple products, please see the response set out in question 2 below.
12. With regard to the category of 'financial situation with a focus on the ability to bear losses', while the majority of respondents agreed with the general notion, several respondents noted that manufacturers cannot specify “the *amount* of losses the target client should be willing and able to afford”. Some respondents also noted that the concept of “net investible assets” is not clearly defined and also contradicts the need for firms to consider the entire financial situation of the client, and not only his net assets. ESMA agrees with comments above and has amended the guidelines accordingly.
13. Several respondents suggest introducing a fixed set of information points, such as “the investor can bear losses to a level specified by the product structure”; “the investor can bear losses up to the invested amount”; and “the investor can bear losses beyond the investment amount”. ESMA agrees with the idea expressed in these comments but believes that the guidelines on this aspect are sufficiently clear and do not require the introduction of a further level of detail.
14. With regard to the category of 'risk tolerance and compatibility of the risk/reward profile of the product with the target market':
- The majority of respondents noted their support for the use of the PRIIPs risk indicator. Various respondents noted that it should be clear that the risk/reward indicator foreseen by the UCITS Directive could also be used, when applicable. ESMA agrees and has amended the guidelines accordingly.
 - Some respondents noted that the ‘risk/reward profile’ of a product should not be confused with the ‘risk attitude’, as the first is product-inherent while the second is

attributed to the investor. These respondents noted that depending on how a product is used in a portfolio context it can be compatible with clients with very different risk attitudes. ESMA agrees with the intrinsic difference between the concepts of risk/reward profile and risk attitude. Nonetheless, ESMA believes that, as the purpose of the product governance requirements is to ensure that products are offered and recommended to compatible clients, there is no contradiction in asking manufacturers to specify the attitude to risk that clients should have in relation to risk in order to be included in the target market of the product.

- Some respondents noted that further terminology, such as “balanced” or “conservative” is not sufficiently defined and therefore will not be applied coherently across the market. ESMA notes that the wording used was only included as examples which are purely “illustrative” are not meant to be prescriptive and notes that a guideline has been introduced to specify that manufacturers need to clearly define terminology used in the definition of the target market.

15. With regard to the categories of ‘clients’ objectives and clients’ needs’ respondents’ suggestions included the following:

- merge the two categories of ‘clients’ objectives’ and ‘clients’ needs’ as the difference of the two is not clear enough;
- redefine the categories using only product-specific characteristics (such as ‘green’ or ‘ethical’ investments) and not customer-specific (such as “retirement provision” or “liquidity supply”);
- redefine clients’ objectives purely in terms of ‘investment horizon’ (in line with the PRIIPs recommended holding period);
- specify that not all products seek to address particular clients’ needs (such as ‘green’ or ‘ethical’).

16. ESMA understands the points made and, to avoid any confusion, has decided to merge the two categories of ‘clients’ objectives and needs’.

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.

17. The majority of respondents agreed with the approach proposed by ESMA in paragraphs 18-20 of the draft guidelines on how to take the products’ nature into account. Some specific comments were however raised and are summarised below.

18. Some respondents stated that the draft guidelines fail to acknowledge that certain simple products are suitable for the mass retail market and therefore do not need a detailed target market identification, or – if it is nonetheless required – it should be very generic and simple. The MSG and some respondents asked ESMA to add, in the annex of the guidelines, a

case study on a non-complex UCITS and shares. ESMA has acknowledged in the guidelines that the target market assessment has to be done in an appropriate and proportionate manner considering the nature of the investment product. However, in order to further clarify this aspect ESMA has added in the annex of the guidelines two further case studies on shares and on non-complex UCITS.

19. ESMA has further clarified, in paragraph 22 of the guidelines, how the requirements should be applied to simpler, more mainstream investment products, such as ordinary shares, plain vanilla bonds and non-complex UCITS. Within the guidelines ESMA has explicitly acknowledged that “for some types of investment products the manufacturer may identify the target market categories following a common approach for types of investment products with sufficiently comparable product features (for example due to an external benchmark, or because they belong to a stock-exchange segment with certain requirements)”. This possibility to choose a common approach applies to each target market category impacted by a common feature (for example an external benchmark would lead to a comparability regarding the target market category of “risk tolerance and compatibility of the risk/reward profile” while a stock-exchange segment including only ethical investments would lead to a comparability regarding the target market category “objectives and needs”). In case of comparable products, the assessment of a certain target market category may be used as a pattern for same categories for other comparable products.
20. Some respondents noted that the guidelines should state that the target market should also be defined differently based on the type of client it is designed for. These respondents noted, for example, that manufacturers designing products for professional clients should not be required to define a level of knowledge and experience of the target clients. In addition, target market requirements for products designed for eligible counterparties should be kept to a minimum. ESMA clearly acknowledged in the CP that the MiFID client categorisation framework calibrates conduct of business protections to the needs of each client category and that, in the wholesale market, MiFID allows certain assumptions to be made about clients’ knowledge and experience. ESMA therefore agrees, as set out in its guidelines, that for products designed for the wholesale market (professional clients and eligible counterparties as end clients) the overall assessment of the target market will likely be less comprehensive and detailed. On the other hand, ESMA believes that it is not appropriate to include a general exemption for use of the five categories for the target market definition of wholesale products.
21. The majority of respondents agreed with the proposal that “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”.
22. Some respondents also commented on paragraphs 21-22 of the draft guidelines and noted that manufacturers should be able to propose the types of investment services through which the client could acquire the product. However, given that many investment products can legitimately be distributed through a wide range of channels, the manufacturer should not always be required to specify the distribution method or to go into details about specific acquisition channels. These respondents noted that a strict approach of this draft guideline

could unduly restrict access to mass-retail market products such as UCITS. Lastly, these respondents questioned whether face-to-face, telephone and online distribution should each be considered as acquisition channels. ESMA, on this aspect, has clarified the guidelines, which now state, “The manufacturer should propose the type of investment service through which the targeted clients should or could acquire the investment product. If the product is deemed appropriate for a sale without advice, the firm could also specify the preferred acquisition channel”.

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

23. A majority of respondents expressed their support for the logic of the Guidelines to ensure that both manufacturers and distributors act in the clients’ best interests during all stages of the life cycle of products. Several of these respondents noted the overall balanced approach adopted in the draft guidelines aimed at distributors and welcomed the confirmation of the application of those draft guidelines in a proportionate manner. However, SMSG as well as several respondents invited ESMA further clarify the distributors’ duties depending on the nature of the investment service (in particular with respect to execution or discretionary portfolio management services) or of the product (e.g. mainstream, simple products).
24. ESMA welcomes these comments and wishes to note that paragraphs 43-48 of the guidelines clarify that a distributor should, depending on the type of product and the nature of the investment service(s) it provides, identify the actual target market for the product (based on the manufacturer’s abstract target market and the information and knowledge of its own client base). ESMA notes that, in line with paragraph 60 of the guidelines, a target market always needs to be identified (including when the product is manufactured by an entity not subject to the MiFID II product governance requirements) and that this target market should consist of all categories listed in paragraph 18 of the guidelines. The identification of the target market would be subject to proportionality as mentioned above and in paragraphs 34-42 of guidelines. The level of granularity or abstraction of the distributor’s target market would depend on the nature of the product and the investment service(s) it provides. The guidelines acknowledge that when distributors carry out execution services under the execution-only regime, firms would not be able to conduct an assessment of the actual target market. To avoid that such situations lead to gaps in taking client’s best interests into account, distributors, when defining their product assortment (i.e. the products that will be offered, to whom, and through the provision of which investment services), 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. The guidelines further explain that when the intended service would not allow for a more refined assessment of the manufacturer’s target market, the outcome of the distributors’ assessment may be that the manufacturer’s more abstract target market will be used.
25. For some stakeholders the identification of a target market by the distributor is going beyond the Level 1 or Level 2 requirements. Some respondents also invited ESMA to clarify that the product governance rules and the guidelines on target market identification do not apply to services. Several respondents commented that in their opinion (passive)

RTO and/or discretionary portfolio management do not qualify as distributing (“offering or recommending”) a product and therefore do not trigger the application of the product governance requirements and of the draft guidelines for distributors. For some other stakeholders portfolio managers were on the contrary clearly subject to product governance obligations. Some other stakeholders expressed contradictory opinions with respect to a distributor target market when products are to be distributed via advice, with a majority of them stressing that only in this case distributors can have a clear understanding of their client base and a critical view on the manufacturer’s target market while few others stated that the suitability assessment removes the need for having a more concrete/granular target market.

26. ESMA is of the view that in accordance with Recital 15 and Article 10(1) of the MiFID II Delegated Directive offering, recommending or selling an investment product also includes the investment services of portfolio management and reception and transmission of orders’
27. For certain respondents, the draft Guidelines seemed to imply a preference for advised sales concerning more complex products and products with greater risks. ESMA notes that MiFID II does not imply that products should only or rather be sold with advice and the paragraphs 43-48 should be read with this in mind. While MiFID II does not express a preference for advised or non-advised sales, the product governance rules require distributors to actively choose the appropriate distribution strategy so that clients’ best interests are taken into account.
28. Contradictory views were also conveyed concerning the division of responsibilities between manufacturers and distributors, with few arguing that only distributors can and should identify the target market, few others mentioning that the larger the distribution network, the more reliance a manufacturer is likely to place on the distributor to identify the target market, while for few others the description of the target market is the responsibility of the manufacturer (as also required under PRIIPs). Several respondents argued that the draft guidelines for distributors could lead to unintended consequences by impacting open architecture models and restricting the range of investment products available to clients, or by reducing liquidity on secondary markets (as products would only be traded by distributors having a relation with the manufacturers). ESMA wishes to remind that both Level 1 and Level 2 product governance rules specifically include obligations for manufacturers and distributors and their objective is clearly not to hinder open architecture models but on the contrary to contribute to facilitating distributors’ tasks to understand products and the end clients to which a product should be distributed, including where there is no direct manufacturer-distributor relationship.

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

29. Several respondents agreed with the principle that the identification of the target market by the distributor should be based on the same list of categories used by the manufacturer as this should ensure consistency between manufacturers’ and distributors’ approaches. Some of them mentioned that it should be possible (both for manufacturers and distributors) to have a “bulk target market” for types of products / products with same characteristics instead of requiring a target market per product. As mentioned above,

ESMA has considered these arguments and acknowledged that a common approach for some types of investment products with sufficiently comparable product features may be applied.

30. While the manufacturer's theoretical target market should be taken into account, few respondents mentioned that the reference to distributors "generally" respecting the manufacturer's target market should be clarified in order not to limit the distributors' freedom. In addition, for retail mass-market products, distributors should be able to rely on the target market identified by the manufacturer. Others invited ESMA to clarify what additional level of granularity is expected for simple products (e.g. UCITS).
31. Several stakeholders argued against requiring distributors to analyse in depth their client base and the use of any available data. ESMA would like to point that Article 10 of the Delegated Directive is clearly requiring distributors to use information on their own clients as well as to identify and assess the circumstances and needs of the clients they intend to focus on. Few others noted that it would be inappropriate for distributors to focus on "subjective" information (relating to their existing clients) since target market is a general definition that should be applicable to prospective clients as well. ESMA agrees with this last comment and included references to "prospective" clients as well.

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

32. Several stakeholders welcomed the reference to recital 18 of the MiFID II Delegated Directive and the acknowledgement that 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. Divergent views were however expressed on paragraph 42 of the draft guidelines, with some arguing that such outcome is detrimental for clients and distributors should not let clients operate on a non-advised basis after warning them that the firm is not in a position to assess compatibility with products while some others deemed such an approach appropriate and fully in line with the proportionality principle. ESMA reminds that product governance are without prejudice to suitability (or appropriateness) assessments and that, in line with certain stakeholders, if a client falls within the target market, this should not automatically mean that the product is suitable for a client.
33. Several stakeholders also mentioned that:
- footnote 16 appears to contradict paragraph 39 of the draft guidelines and should therefore be deleted, whereas some others acknowledged that distributors may voluntarily decide to consider some client information they have also in case of execution only;
 - ESMA should further clarify the distinction between the assessment and disclosure criteria per type of investment services (e.g. for execution-only all criteria of the target market being for disclosure-only, for execution with appropriateness, the categories to be considered by distributors would be the types of clients and the knowledge and

experience while the risk, ability to bear losses and objectives/needs would be simply disclosed, and at last all criteria would be assessed for suitability). SMSG concurred that in such cases the distributor should not be required to verify the other target market criteria described by the manufacturer.

34. ESMA points out that the guidelines acknowledge that the obligation of distributors to identify and assess the actual target market apply in a proportionate manner depending on the type of services provided. In particular, it is recognised that when providing execution services under appropriateness and execution-only regime, the extent to which these obligations apply is more limited compared to when providing services subject to suitability. The level of client information to be used for the purposes of identifying and assessing the target market is typically more extensive when firms provide services requiring a suitability test (for which the acquisition of a wider set of information is necessary). This is reflected in paragraph 44 of the guidelines. Nevertheless, it remains in the firms' responsibility and in accordance with their duty to act in the best interests of their clients, to decide the range of products they intend to offer, to whom and through the provision of which investment services. When doing so - as clarified in paragraph 46 of the guidelines - it is necessary that firms take into account the specific characteristics of the products considered (especially their complexity/risk features, or other relevant features such as, for example, innovation), as well as the existence of significant conflicts of interests as well as the level of protection afforded to clients at the point of sale depending on the type of service provided. This means that, for example, if a distributor only operates through an online brokerage platform under appropriateness, the distributor would only be able to assess the categories of 'types of clients' and 'knowledge and experience'. The distributor could therefore choose to warn clients that it is not in the position of conducting a thorough assessment of their compatibility with the target market of the products offered through the platform and disclose the target market.
35. ESMA is of the view that the existing text of the guidelines is already in line with the described approach on how the interaction between distributors' product governance obligations and the investment service provided should be intended and apply in practice. Therefore, no further changes to guidelines have been made.

Distribution strategy of the distributor

36. Few respondents noted that the scope of products that may be distributed via execution-only should not be narrowed down because of these guidelines. Some stakeholders invited ESMA to clarify how the distribution strategy impacts the target market identification by the distributor, with some stakeholders arguing that there should be no automatic dependence between the nature/complexity of a product and the distribution service. Few other respondents noted that taking into account the distribution strategy identified by the manufacturer should not result in granting certain distributors exclusive rights. ESMA agrees with these comments and wishes to clarify that the application of these rules is without prejudice to competition rules. Few other respondents suggested deleting paragraph 46 of the draft guidelines as distributors should not be allowed to ignore the target market and the distribution strategy suggested by the manufacturer. Some even stressed that especially when there is no relationship between the manufacturer and the

distributor, it is important that manufacturers indicate a distribution strategy and establish which services may or may not be applicable. ESMA takes note of these last concerns and agrees that distributors should pay particular attention to the distribution strategy defined by the manufacturer, especially when specific features of the product mandate a distribution through services offering higher protection to clients. However, ESMA considers that paragraph 51 of the guidelines stresses that any such deviations should only take place after a thorough analysis and the decision should be reported to the manufacturer and therefore is sufficiently balanced.

Reporting

37. While several respondents welcomed the proportionate approach and the guidance provided with respect to the information to be reported by distributors to manufacturers, few others invited ESMA to provide further clarifications concerning the data to be reported for example in case of mass retail products or of non-advised sales (when distributors would not be able to indicate whether sales were within the target market or not).

38. Certain stakeholders argued more generally that the relevant flow of information between manufacturers and distributors might not be efficient without further standardisation concerning the description and application of the target market concept.

39. In light of the above comments, ESMA has further clarified the type of information to be reported. In addition, ESMA has clarified that distributors' target market could be the same as the one of the manufacturer. Reporting to manufacturers should therefore be limited (as products would be mass retail products and therefore sales outside the target market de facto inexistent) to, for instance, any potential complaints received by a number of clients.

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.

40. Almost all respondents welcomed the acknowledgment of the role of diversification and hedging. While in general the position on hedging was well received, the support for the portfolio approach was more nuanced as described below.

41. Although a majority of these respondents explicitly acknowledged that the target market identification is product related, a recurrent comment concerned the reference to the fact that sales outside the target market should not occur on "a regular basis". Respondents noted that such a strict limitation of sales outside the target might limit portfolio managers' decision-making and go against clients' interests. According to some respondents, this limitation was also too subjective and would raise implementation and supervisory issues. These respondents as well as the SMSG therefore suggested deleting the reference to the "regular basis". Several of them however explicitly noted their support for appropriate documentation and/or disclosure to clients for sales outside the target market in the context of portfolio diversification. Certain consumer representatives also noted that a positive suitability test and documentation of the deviation would be appropriate safeguards. Another comment concerned the expectation that distributors report deviations - due to a

portfolio approach – to manufacturers. For some respondents the final guidelines should clarify that such sales following diversification / hedging purposes should not be deemed to be outside the target market (as it could lead to unintended outcomes, with manufacturers possibly redefining the target market, or to unjustified monitoring of portfolio managers). For some stakeholders, if sales were following a diversification approach the guidelines should clarify that not only sales outside the positive target market but also within the negative target market should be allowed.

42. ESMA considered the above arguments and the MSG and some stakeholders' suggestions to allow for diversification while avoiding abuses (e.g. through limitations of sales within the negative target market, establishing certain thresholds for sales outside the target market as part of a portfolio). ESMA has deleted the reference to the "regular basis" with respect to sales outside the positive target market in paragraph 70 of the guidelines but stresses that any such instances should be justified by the individual facts of the case and the reason for the deviation should be clearly documented. ESMA has also clarified (in paragraphs 54 and 55 of the guidelines) how distributors are expected to report sales outside the positive target market or within the negative target market for diversification or hedging purposes. It should however be noted that the reporting exception granted in paragraph 54 should not apply to the categories 'the type of clients to whom the product is targeted' and 'knowledge and experience'. Also, in a wholesale market context (and line with the guidelines on the application of the target market requirements to firms dealing in wholesale markets), it is likely that the definition of the negative target market will have limited effect and, therefore, sales within the negative target market will occur only in very limited instances, reducing therefore the reporting under paragraph 55 of the guidelines.
43. For certain other respondents, diversification also occurs in the case of non-advised sales when a client, by himself, executes transactions with a view to ensuring diversification. These respondents also argue that as in these cases the execution intermediary would not be able to identify or document deviations from the target market due to client's own diversification strategy, there should be no duties for them, including no duty to report to manufacturers. ESMA wishes to stress that this interpretation/application of the concept of "diversification" is not correct and would empty the concept of product governance rules.
44. Several respondents noted that a reference to diversification and hedging should also be included in the body of the guidelines themselves. ESMA has accepted these requests and has amended the guidelines accordingly.

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?

45. The majority of respondents considered that the level of guidance provided in the draft guidelines regarding the way distributors should apply product governance requirements with respect to products manufactured by entities falling outside the scope of MiFID II was in line with the legislative text.

46. Nevertheless, a number of respondents noted that, in practice, the situation where the manufacturer falls outside the scope of MiFID II is likely to be frequent. These respondents consequently noted that applying the information gathering procedures set out in paragraphs 51 to 54 of the draft guidelines to the distribution of the more common and simpler investment products (e.g. plain vanilla bonds and shares issued by corporate issuers or shares/units of non-complex UCITS) would impose a disproportionate burden on firms. A number of respondents also expressed the view that it would be beneficial to clarify the extent to which distributors may place reliance on the information set out by a non-MiFID manufacturer in a UCITS KIID, PRIIPS KID or a prospectus issued in compliance with the Prospectus Directive. ESMA notes the clarifications provided within the Delegated Directive with respect to reliable publicly available information as one produced to meet regulatory requirements and agrees that, in line with some comments, when a non-MiFID manufacturer has issued one of the information documents listed above, the distributor is not required to enter into an agreement with the manufacturer for the purpose of the product governance target market requirements.
47. For some stakeholders, the draft guidelines, by stating that distributors need to provide a target market for products manufactured before 3 January 2018 but distributed after that date, shift the responsibility for product governance requirements on distributors. In their opinion, such a position raises liability and legal certainty issues. Many of them suggested that the Guidelines should only state that product governance requirements, and in particular providing the target market, are the manufacturers' responsibility as of 3 January 2018. ESMA has considered these concerns but notes that MiFID II foresees no exemption or grandfathering for products manufactured before but distributed after January 2018. However, ESMA also notes that the PRIIPs Regulation will require PRIIPs manufacturers, as of January 2018, to draw up and publish a KID on their website, including for PRIIPs manufactured before but which would still continue to be made available after that date; this should also facilitate the data gathering information for distributors having to comply with the MiFID II product governance rules and in particular with the target market identification.
48. For others, while the above position was in line with the legal provisions, ESMA could mitigate any implementation issues: i) by encouraging manufacturers to provide the target market, or ii) by requiring manufacturers to set a target market in the next product review cycle, or iii) making it easier for distributors to identify the target market themselves, particularly in the case of simple products, or iv) by excluding this position for products on secondary markets. It should be also mentioned that certain consumer representatives and standard setting bodies supported the position set out in the consultation as it ensured the same protection for all products. Some others invited ESMA to clarify that if in such cases manufacturers provided – on voluntary basis – a target market, distributors can rely on it. ESMA has introduced a clarification in this respect in the guidelines. ESMA has also noted the invitation to clarify that where UCITS/AIFs manufacturers (or even other manufacturers such as in the case of products manufactured before January 2018) apply the MiFID product governance rules, the requirements to provide information to distributors and the return on information back to manufacturers should also apply. ESMA would like to note that it would indeed consider good practice for such reporting to occur, especially in light



of the expectation that MiFID manufacturers would anyway need to assign a target market following the next product review process cycle.

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

49. In general, respondents expressed their support for the objective of strengthening the protection of investors through the clarifications provided in the draft guidelines on the definition of the negative target market. The reference to the application of the proportionality principle when firms have to define the negative target market was particularly appreciated.
50. A number of respondents noted that a negative target market should be defined in very exceptional situations, where the sale of the financial product could be potentially detrimental to a specific category of investors and to whom consequently the product should never be sold. ESMA notes that firms are explicitly required by Article 9(9) of the MIFID II Delegated Directive to identify any group(s) of clients whose needs, characteristics and objectives the investment product is not compatible. ESMA however acknowledges that, for some simpler low-risk mass-market products, the result of the firms’ assessment can be that there is no group of clients for which the product is not compatible.
51. Several respondents agreed with the ESMA proposal even if they pointed out that the definition of a specific negative target market could be disproportionate in case of mass retail market or non-complex products (e.g. plain vanilla instruments or funds). In the same direction, others suggested that for relatively straight-forward products for the mass retail market, such as equity products, it should be sufficient to say that – if the target market includes most retail investor who will accept the capital risk – the negative target market would be those who aim for complete capital preservation. As previously mentioned, ESMA has added some further case studies in the annex of the guidelines to set out examples of how a negative target market can be defined for shares and non-complex UCITS.
52. Some respondents expressed a preference for a binary approach (where the negative target market corresponds to what does not fall in the positive one), since the possibility of having a third category of clients (being neither in the positive nor in the negative target market) could be difficult to envisage and might even enhance the risk of mis-selling. ESMA notes that the majority of respondents supported the approach set out in the Consultation. Furthermore, while a binary approach might appear simpler to apply, the identification of a group of target clients for which the product is compatible does not always automatically imply that the product is not compatible with all other clients. For example, a “green” or “ethical” investment fulfils the objectives and needs of certain clients but is not necessarily incompatible with other clients.
53. On the deviations from the target market that distributors should report to manufacturers, a number of respondents noted that this reporting should be proportionate to the risk of a product and to the frequency of the deviation. Some observed that the provision of portfolio management (which implies the application of portfolio diversification techniques) is not compatible with a strict application of the draft guidelines on the negative target market. In

particular, respondents claimed that it would be disproportionate to require portfolio managers to define a negative target market for every asset they include in clients' portfolios. On the topic of sales outside the target market, ESMA has further clarified that reporting requirements are subject to the proportionality principle, may be done in aggregated form and does not generally need to be done on an instrument-by-instrument basis (e.g. for products with a "bulk" target market). Furthermore, with specific regard to the reporting on sales outside of the target market please refer to ESMA's feedback on the topic of portfolio management, portfolio approach, hedging and diversification.

54. Few respondents questioned whether in the context of non-advised services the reports for the deviations from the target market are required. ESMA had already acknowledged in the draft guidelines that when clients operate on a non-advised basis, distributors might not be in the position to assess their full compatibility with products. ESMA had however also added that, even for non-advised sales, firms that recommend or actively market a product are expected to conduct a thorough assessment of the target market. Finally, ESMA refers to the clarifications in the previous paragraph concerning reporting in an aggregated form or the possibility to use a summary of information on types of clients, complaints received and questions suggested by the manufacturer to a sample of clients for feedback.
55. Consumer associations responding to the consultation expressed their support and agreement with the guidelines on the definition of a negative target market, stressing the fact that sales to investors falling within the negative target market should be even more restricted than sales to investors falling outside the positive target market. Some even suggested introducing a complete ban of sales to clients included in the negative target market. ESMA feels the approach proposed in the guidelines reaches a correct balance as the guidelines clearly state the sales within the negative target market should be a rare occurrence and significantly justified, but would not introduce a strict, full, ban as there might always be a situation where clients might be allowed access to these products (and where all other MiFID requirements are complied with).

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

56. The majority of respondents agreed with the approach suggested in the draft guidelines, notably with respect to the guidance provided to distinguish between professional clients and eligible counterparties acting as part of the intermediation chain or acting as end-clients.
57. A few respondents suggested that more consideration be given to proportionality in the guidelines with respect to the type of client. Others suggested that the guidelines provide that investment firms dealing with professional clients or eligible counterparties could assume that such clients fall by default in the target market of any type of financial product. On this point, please see the ESMA response to a similar issue raised in Question 2.
58. A number of respondents expressed concerns in relation to the distinction made in paragraphs 72 and 73 of the draft guidelines between *per se* professional clients and

elective professional clients. These respondents expressed the view that paragraph 73 was not compliant with Article 54(3) of the MiFID II Delegated Regulation¹¹. ESMA notes that Annex II of MiFID II, clearly states that elective professional clients “should not be presumed to possess the knowledge and experience comparable to per se professional clients”. ESMA therefore has confirmed the draft guidelines on this topic.

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

59. Various comments were submitted by respondents to the public consultation with reference to Question 8. Numerous of these comments related to issues already mentioned in other sections of this feedback statement and are not repeated here again.
60. Some respondents asked ESMA to better clarify the definition of ‘manufacturer’. For example, respondents expressed their concern about situations where there are two co-manufacturers (e.g. when an investment firm advises corporate issuers on the launch on a new product, or when an investment firm acts as the arranger in respect of an issuance by a special purpose vehicle). Respondents also asked ESMA to better clarify the definition of ‘distributor’, as the entity that is in contact with the end client. ESMA notes that the guidelines use the terms ‘manufacturer’ and ‘distributor’ as set out in the MiFID II Delegated Directive, which provide further clarifications on these definitions, while taking an intentionally broad approach in order to ensure that the requirements apply to a large scope of firms and situations. ESMA also notes that Article 9(8) of the Delegated Directive clarifies that investment firms collaborating with other firms, including non-MiFID entities, to “manufacture” a product are required to outline their mutual responsibilities in a written agreement. ESMA would expect that this agreement would also address issues related to manufacturers’ duties concerning the monitoring and the review of products.
61. Respondents asked ESMA to clarify the interaction between the PRIIPs Regulation and the MiFID II product governance requirements. Since under PRIIPS manufacturers are required to include in the Key Information Document (KID) a description of the type of retail investor to whom the PRIIP is intended to be marketed, some respondents questioned whether/how PRIIPS’ manufacturers should incorporate the MiFID II target market within the KID. While the reference to a target market set out in the PRIIPs Regulation and in MiFID II serve related purposes and while ESMA has stated that distributors can and should rely on information provided through the KID, the nature of the requirements and the granularity of the information to be provided in the KID is naturally more limited compared to MiFID rules.
62. Overall, ESMA notes - as already illustrated in the Background section of the CP – that these guidelines do not aim to address all aspects of the MiFID II product governance requirements, but focus instead on the target market assessment, as this aspect was identified as the most important one for ensuring the common, uniform and consistent application of the new requirements. Nevertheless, ESMA does not exclude to develop

¹¹ Commission Delegated Regulation (EU) 2017/565.



further Level 3 work (e.g. Q&As) on other aspects of the MiFID II product governance framework.

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.

63. Many respondents noted that it was difficult to estimate costs stemming from the implementation of the guidelines. Other respondents acknowledged that the majority of costs stem directly from the MiFID II requirements rather than from ESMA guidelines. In some cases, respondents noted that costs and resources needed for the implementation of the new framework would be fully compensated by the benefits connected to it.

64. Several respondents identified the following costs as relevant, but did not provide quantification of these costs:

One-off

- initial significant IT investments;
- procedural enhancements (business, compliance and legal, including procedures to inform the manufacturers of deviations from the target market and the activities needed to draft target market for product manufactured by entities non subject to MiFID rules)¹²;
- training costs (sales staff);
- legal costs, including costs related to the new distribution agreements (particularly in cases of manufacturers not subject to MiFID requirements) and those related to the update of the existing agreements;

On-going costs

- running IT costs (technology and use/protection of data);
- control and compliance cost;

¹² On the manufacturing side, some respondents noted that they would need at least three or four people working full time would be necessary (target market and relationships between manufacturer and distributor).



- costs related to the exchange of information between distributors and manufacturers.

65. For some respondents the ability to define a standard at industry level (for the ad hoc reporting that should be developed or the data feeds that should be implemented) was described as key to reduce overall costs. In some cases, quantitative details have been added (e.g. an overall estimation of 500K € one-off and 200K € running, by individual entity, has been provided)



3.4 Annex IV - 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/EU¹³ (MiFID II);
 - ii. Article 16(3) of MiFID II;
 - iii. Article 24(1) and 24(2) of MiFID II;
 - iv. Articles 9 and 10 of the Commission Delegated Directive (EU) 2017/593¹⁴ (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 investment products.

When?

3. These guidelines apply from 3 January 2018.

II. Purpose

4. The purpose of these guidelines is to provide more clarity on the product governance 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 V includes a number of illustrative examples. These examples do not form part of

¹³ 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).

¹⁴ Commission Delegated Directive (EU) 2017/593 of 7 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits (OJ L 87, 31.3.2017, p. 500-517).



the guidelines but instead aim to assist firms and competent authorities in understanding how the guidelines apply.

III. Definitions

6. For the purpose of these guidelines, 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 and activities (within the meaning of Article 4(1)(2) of MiFID II), 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) (as defined in Article 5(1)(a) of the AIFMD¹⁵) when 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 Directive¹⁶ and Article 6(4)(a) and (b) of the AIFMD);
- 'investment product' means a financial instrument (within the meaning of Article 4(1)(15) of MiFID II) or a structured deposit (within the meaning of Article 4(1)(43) of MiFID II);
- 'manufacturer' means, taking into account 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, taking into account 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.

¹⁵ Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 (OJ L 174, 01.07.2011, p.1-73).

¹⁶ Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (OJ L 302, 17.11.2009, p. 32).



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 guidelines on ESMA's website in all official languages of the EU.
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

3.4.1 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 investment product, 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.

3.4.2 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 that 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 investment products. The list of the categories is cumulative: when assessing the target market, each manufacturer should use each of those categories. In doing so, a manufacturer should 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 18-24 of the guidelines).

15. When detailing/describing each one of these categories, manufacturers should take into account the relationship between different categories since they all contribute to the definition of the target market for a given product.
16. Manufacturers should not exclude any of the five below mentioned categories. If, in the manufacturers view, these five categories are too restrictive to identify a meaningful target market, additional categories may be added. In the decision, whether to use such additional categories or not, manufacturers may take into account the characteristics of the information-channels with distributors. For example, in order to facilitate the exchange of information with distributors and to foster open architecture, manufacturers may limit the use of additional categories to cases where these are essential to define a meaningful target market for the product.
17. Manufacturers need to identify a potential target market¹⁷. As they usually do not have direct client contact, and in accordance with subparagraph 2 of Article 9(9) of the MiFID II Delegated Directive, this means that their target market identification may be based *inter alia* on their theoretical knowledge and experience of the product.
18. Manufacturers should use the following list of five 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 be made according to the MiFID II client categorisation of “retail client”, “professional client” and/or “eligible counterparty”.
 - (b) Knowledge and experience: The firm should specify the knowledge that 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 could 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 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 percentage of losses target clients should be able and willing to afford (for

¹⁷ See Article 9(9) of the MiFID Delegated Directive.

example, from minor losses to total loss) and if there are any additional payment obligations that might exceed the amount invested (for example, margin calls). This could also be phrased as a maximum proportion of 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 use the risk indicator stipulated by the PRIIPs Regulation or the UCITS Directive, where applicable, to fulfil this requirement.
- (e) Clients’ Objectives and Needs: The firm should specify the investment objectives and needs of target clients that a product is designed to meet, including the wider financial goals of target clients or the overall strategy they follow when investing. For example, reference could be made to the expected investment horizon (number of years the investment is to be held). Those objectives can be “fine-tuned” by specifying particular aspects of the investment and expectations of targeted clients. The particular clients’ objectives and needs a product is intended to fulfil may vary from specific to more generic. For example, a product may be designed to meet the needs of a specific age demographic, to achieve tax efficiency based on clients’ country of tax residence, or be designed with special product features to achieve specific investment objectives such as “currency protection”, “green investment”, “ethical investment”, etc., as relevant.

19. 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, obviously it will be compatible with a sophisticated level of knowledge and experience.

20. In order to avoid the risk of misinterpretations and misunderstandings, manufacturers should clearly define the concepts and terminology used when defining the target market across the five categories listed above.

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

21. The identification of the potential target market 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 product including its complexity (including costs and charges structure), risk-reward profile or liquidity, or its innovative character.

22. Consequently, for more complicated products, such as structured products with complicated return profiles, the target market should be identified with more detail. For simpler, more common products it is likely that the target market will be identified with less detail¹⁸:

- For some types of investment products the manufacturer may identify the above-mentioned target market categories referred to in paragraph 18 following a common approach for financial instruments of one type with sufficiently comparable product features (for example due to an external benchmark, or because they belong to a stock-exchange segment with certain requirements).
- Depending on the investment product, the description of one or more of the above-mentioned categories may be more generic. The simpler a product is, the less detailed a category may be.

23. 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.

24. 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

25. 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.

26. 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 could also specify the preferred acquisition channel.

¹⁸ See Recital 19 of the MiFID II Delegated Directive.

3.4.3 Guidelines for distributors

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

27. The distributor's target market identification (i.e. the 'actual' target market for that product) 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 actual target market identification should occur at an early stage, when the firm's business policies and distribution strategies are defined by the management body and, on an *ex-ante* basis (i.e. before going into daily business).
28. 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.
29. 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.
30. Firms should especially focus on the investment services through which the products will be offered to their respective target markets. In this context, ESMA expects 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).¹⁹ 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 offered in accordance with appropriateness or suitability requirements, so as to grant a higher degree of protection to clients.
31. 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

¹⁹ 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'.

available to (existing or prospective) 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.

32. 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 existing or prospective clients, it should refrain from including the product in its product assortment (i.e. the products that will be offered, to whom, and through the provision of which investment services).

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

33. 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, characteristics and objectives it had been designed, instead of another group of clients with whom the product may not be compatible.

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

34. Distributors should use the same list of categories used by manufacturers (see paragraph 18), 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 investment products and the type of investment services they provide.
35. As the manufacturer has to specify the potential target market based on its theoretical knowledge and experience with a similar product, it will determine the product's target market without specific knowledge of individual clients. Therefore, the manufacturer's assessment will be conducted with a more general view of how the features/nature of a product would be compatible for certain types of investors, based on their knowledge of the financial markets and their past experience with similar products. In this way, a set of boundaries is introduced on a more abstract level.
36. 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 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 its own clients). Distributors should use the manufacturer's more general target market assessment together with existing information on their clients or prospective 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.

37. To this end, distributors should conduct a thorough analysis of the characteristics of their client base, i.e. existing clients, as well as prospective clients (for example, a distributor may have 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 that may be at the distributors' disposal and gathered through sources other than the provision of investment or ancillary services.
38. When refining the manufacturer's target market, the distributor should not deviate from the fundamental decisions made therein. However, distributors cannot just rely on the manufacturer's target market without considering how the target market defined by the manufacturer would fit to their client base. For that purpose, distributors should implement and maintain a dedicated process, which needs to be run in all cases. This process is subject to proportionality, i.e. the scrutiny and – if necessary – the refinement of the manufacturer's target market by the distributor should be more intensive for more complex products and could be less intensive in case of simpler, more common products. If, as a result of the process, the distributor comes to the conclusion that the target market of the manufacturer does not need to be refined, the distributor may use the manufacturer's target market as it is.
39. Usually, the target market assessment of the distributor will occur after the manufacturer has communicated its target market to him. However, it is possible that manufacturer and distributor could define both the manufacturer's target market and the distributor's target market, including any review and refinement process, at the same time. This could, for example, occur where the manufacturer and the distributor jointly develop a common target market standard for the products they usually exchange. Both the manufacturer and the distributor retain their responsibility for their obligations to identify a target market as described in MiFID II and the MiFID II Delegated Directive and further specified in these guidelines to identify a target market. A manufacturer has still to take reasonable steps to ensure that products are distributed to the identified target market and a distributor has to ensure that products are offered or recommended only when this is in the interest of clients.
40. 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

41. 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 21 to 24.
42. Where the manufacturer has identified a target market for simpler, more common products the distributor's target market identification does not necessarily have to result in a refinement of the manufacturer's target market.

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

43. 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, 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 paragraph 41 above), but also on the type of investment services that firms provide.
44. 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, compared to other services provided under the appropriateness regime or under execution-only.
45. It is therefore expected that when distributors define their product assortment, 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 distributors 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 which is limited to the sole categories of clients' knowledge and experience (see paragraph 18(b)); where they only conduct execution services under the execution-only regime, not even the assessment of clients'

knowledge and experience will usually be possible²⁰ In this respect, firms should pay particular attention to the distribution strategy suggested by the manufacturer (see paragraphs 26, 49 to 51).

46. 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 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).
47. 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.
48. On the contrary, if distributors intend to approach clients or prospective clients in any way to recommend or actively market a product or consider that product for the provision of portfolio management, then a thorough assessment of the target market should always be conducted.

Distribution strategy of the distributor

49. The distributor should take the distribution strategy identified by the manufacturer into account and review it with a critical look. However, ultimately, including when a manufacturer is an entity not subject to MiFID II and thus it is not obliged to identify a distribution strategy, the distributor should define its own distribution strategy in light of information on its client base and type of services provided.
50. 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

²⁰ As explained above (see paragraph 36), 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.

still decide that the characteristics of its existing or prospective 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 their best interests.

51. 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, should be offered through investment advice, the distributor could still make that product available through execution services to a specific segment of clients. In these situations, ESMA expects that the distributor would do so only after a thorough analysis of the features of the products and 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).

Portfolio management, portfolio approach, hedging and diversification

52. When providing investment advice adopting a portfolio approach and portfolio management to the client, the distributor can use products for diversification and hedging purposes. In this context, products can be sold outside of the product target market, if the portfolio as a whole or the combination of a financial instrument with its hedge is suitable for the client.
53. The identification of a target market by the distributor is without prejudice to the assessment of suitability. This means that, in certain cases, permissible deviations between the target market identification and the individual eligibility of the client may occur if the recommendation or sale of the product fulfils the suitability requirements conducted with a portfolio view as well as all other applicable legal requirements (including those relating to disclosure, identification and management of conflicts of interest, remuneration and inducements).
54. The distributor is not required to report sales outside of the positive target market to the manufacturer if these sales are for diversification and hedging purposes and if these sales are still suitable given the client's total portfolio or the risk being hedged.
55. Sales of products into the negative target market should always be reported to the manufacturer and disclosed to the client, even if those sales are for diversification or hedging purposes. Moreover, even if for diversification purposes, sales into the negative target market should be a rare occurrence (see also paragraphs 67-74).

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

56. Article 16(3) MiFID II and Articles 9 and 10 of the MiFID II Delegated Directive require manufacturers and distributors 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.
57. 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 of the 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.
58. 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. Any such information is subject to the proportionality principle and may generally be in an aggregated form and does not generally need to be on an instrument-by-instrument or sale-by-sale basis. However, instrument-specific information should be provided in cases with particular relevance for certain individual instruments (e.g. if the distributor comes to the conclusion that a target market for a specific product was wrongly determined).
59. In relation to the reporting of information on sales outside the manufacturer's target market, distributors should be able to report any decisions they have taken to sell outside the target market or to broaden the distribution strategy recommended by the manufacturer and information on sales made outside the target market (including sales within the negative target market), taking into account the exceptions as noted in paragraph 54.

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

60. 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 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.
61. 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,²¹ (see paragraph 34). 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 (see paragraph 21).
- **Information gathering process:** 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 market²². Where all relevant information is not publicly available (for example, through the PRIIPs²³ 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 requirements²⁴. For example, information disclosed in compliance with requirements in the Prospectus Directive, the Transparency Directive, the UCITS Directive, the AIFMD Directive or third-country equivalent requirements are acceptable.

62. The obligation referred to in paragraph 61 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 product²⁵. Thus, information about simpler, more common products, such as ordinary shares, will usually not require an agreement with the manufacturer but can be derived from the manifold information sources published for regulatory purposes for such products.

63. Where the distributor is not in a 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 date of application of MIFID II.

64. Products manufactured and distributed before 3 January 2018 should not fall within the scope of the product governance requirements as defined by MiFID II.

²¹ See Article 10(1) of the MiFID II Delegated Directive.

²² See subparagraph 3 of Article 10(2) of the MiFID II Delegated Directive.

²³ Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs) (OJ 352, 09.12.2014, p. 1–23).

²⁴ See Article 10(2) of the MiFID II Delegated Directive.

²⁵ See subparagraph 3 of Article 10(2) of the MiFID II Delegated Directive.

65. Products which were 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. When the target market has been identified by the manufacturer (on a voluntary basis / on the basis of commercial agreements with distributors) in line with these guidelines, the distributor, after reviewing it with a critical look, could rely on this target market identification.
66. 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) of MiFID II after 3 January 2018. The distributor should then consider this target market in its own review process.

3.4.4 Guidelines on issues applicable to both manufacturers and distributors

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

67. The firm needs to consider whether the product would be incompatible with certain target clients (“negative” target market)²⁶. When doing so, the firm should apply the same categories and principles as stated above in paragraphs 13-20 and 34-40. 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.
68. 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.
69. 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

²⁶ See Articles 9(9) and 10(2) of the MiFID II Delegated Directive.

incompatible, while the group of clients for whom the financial instrument is not compatible might be large for a more complex product).

70. 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, the reason for the deviation should be clearly documented and, where provided, included in the suitability report.
71. 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.
72. 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 that is in the 'grey' area, i.e. between the positive and negative target markets.
73. It is important that if the distributor becomes aware, for example, through the analysis of clients' complaints or other sources and data, 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 will be 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.
74. 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 that

are recurrent) should be reported to the manufacturer taking into account the exceptions as noted in paragraph 54.

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

75. 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 Articles 16(3) and 24(2) MiFID II specify 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 client-type category referred to in paragraph 18(a).

76. 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”.

77. 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.

78. 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 should 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

79. 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.

80. 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 clients²⁷. As such, when assessing the appropriate target market for a particular

²⁷ See subparagraph 3 of Article 16(3) and Article 24(2) of MiFID II.

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

81. 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 client²⁸. 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.
82. 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 clients²⁹. For example, the contrast in approach should take account of the differences in the knowledge and experience profiles of these different client categories.
83. It is possible that some products (for example those that are suitable for distribution in mass retail markets) will have a widely defined target market that 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 that 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

84. The MiFID regulatory framework 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).

²⁸ See Annex II of MiFID II.

²⁹ See subparagraph 2 of section II.1 of Annex II of MiFID II.



85. 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.



3.5 Annex V - 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

- Type of clients: retail, professional clients and eligible counterparties
- Clients' 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
- Clients' financial situation with a focus on the ability to bear losses: ability to tie money up for six years and to bear a 100% capital loss
- Clients' 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
- Clients' objectives and needs: looking for the possibility of capital growth only over the medium-term (six-year term investment horizon), and expectation that, at expiry, none of the stocks will be worth less than 50% of the initial valuation.
- Clients who should not invest (the 'negative target market'): clients lacking the requisite knowledge and experience; clients with an investment horizon shorter than [x]; and clients lacking the ability to tolerate the risks of the investment are deemed incompatible with the characteristics of this product.
- 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.

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

- Type of clients: retail, professional clients and eligible counterparties



- Clients' 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
 - 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
- Clients' financial situation with a focus on the ability to bear losses: ability to tie money up for six years
- Clients' 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
- Clients' objectives and needs:
 - looking for possibility of capital growth only
 - looking for the potential of earning a greater return than in a comparable deposit account
 - six-year term investment horizon
- 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

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)

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.

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 same product, without any packaging, 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 that 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).

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.

Case-study 4: Target market assessment of a share

Product

Ordinary bearer share of a European blue-chip stock-corporation company from the automotive industry, listed on a regulated market in a prime index.



Target market

- Type of clients: retail, professional clients and eligible counterparties
- Clients' knowledge and experience: clients with basic capital markets knowledge or experience about shares. Given the amount of information available through e.g. press and mandatory disclosures, knowledge and experience requirements for such products are generally low.
- Clients' financial situation with a focus on the ability to bear losses: ability to bear 100% capital loss.
- Clients' risk tolerance and compatibility of the risk/reward profile of the product with the target market: due to the volatility of stock markets and specific risk if investing in individual company shares, clients should have a medium to high-risk³⁰ tolerance. They should be willing to accept price fluctuations in exchange for the opportunity of higher returns.
- Clients' objectives and needs: mass-market shares are compatible with the needs of clients who seek capital growth or potential dividend returns. Mass-market shares, that are very liquid and easily disposable, can be suitable for any investment horizon.
- Clients who should not invest (the 'negative-target market'): this product is deemed incompatible for clients which:
 - are looking for full capital protection or full repayment of the amount invested
 - are fully risk averse/have no risk tolerance
 - need a fully guaranteed income or fully predictable return profile

Distribution channel:

The product is eligible for all distribution channels (e.g. investment advice, portfolio management, non-advised sales and pure execution services)

Case study 5 – Target market assessment of a non-complex UCITS

Product

Non-complex UCITS fund primarily investing in investment grade European bonds (government, money-market or corporate bonds).

³⁰ In line with paragraph 20 of the guidelines, firms should clearly define concepts and terminology used



Target market

The type of clients to whom the product is targeted

- Type of clients: given the nature of non-complex UCITS funds: retail, professional clients and eligible counterparties
- Clients' knowledge and experience: clients with basic capital markets knowledge or experience (about funds' and bonds' characteristics and risks)
- Clients' financial situation with a focus on the ability to bear losses: clients that can bear a [x]%³¹ capital loss
- Clients' risk tolerance and compatibility of the risk/reward profile of the product with the target market: due to the volatility of the bond market, the product has an [x]³² risk & reward profile and is therefore compatible with clients need to have a low to medium³³ risk tolerance. They should be willing to accept price fluctuations in exchange for the opportunity of possible higher returns
- Clients' objectives and needs: depending on the duration of the product, the UCITS may be suitable for clients who seek capital growth and have a medium-term investment horizon (at least 3 years³⁴)
- Clients who should not invest (the 'negative-target market'): this product is deemed incompatible for clients which:
 - require full capital protection and / or seeking on-demand full repayment of the amounts invested
 - are fully risk averse/have no risk tolerance

Distribution channel

The product is eligible for all distribution channels (e.g. investment advice, portfolio management, non-advised sales and pure execution services)

³¹ The firm should specify the percentage based on the characteristics of the product.

³² The firm should use the risk indicator of the UCITS KIID.

³³ In line with paragraph 20 of the guidelines, firms should clearly define concepts and terminology used

³⁴ The firm should quantify the investment horizon based on the specific duration of the product