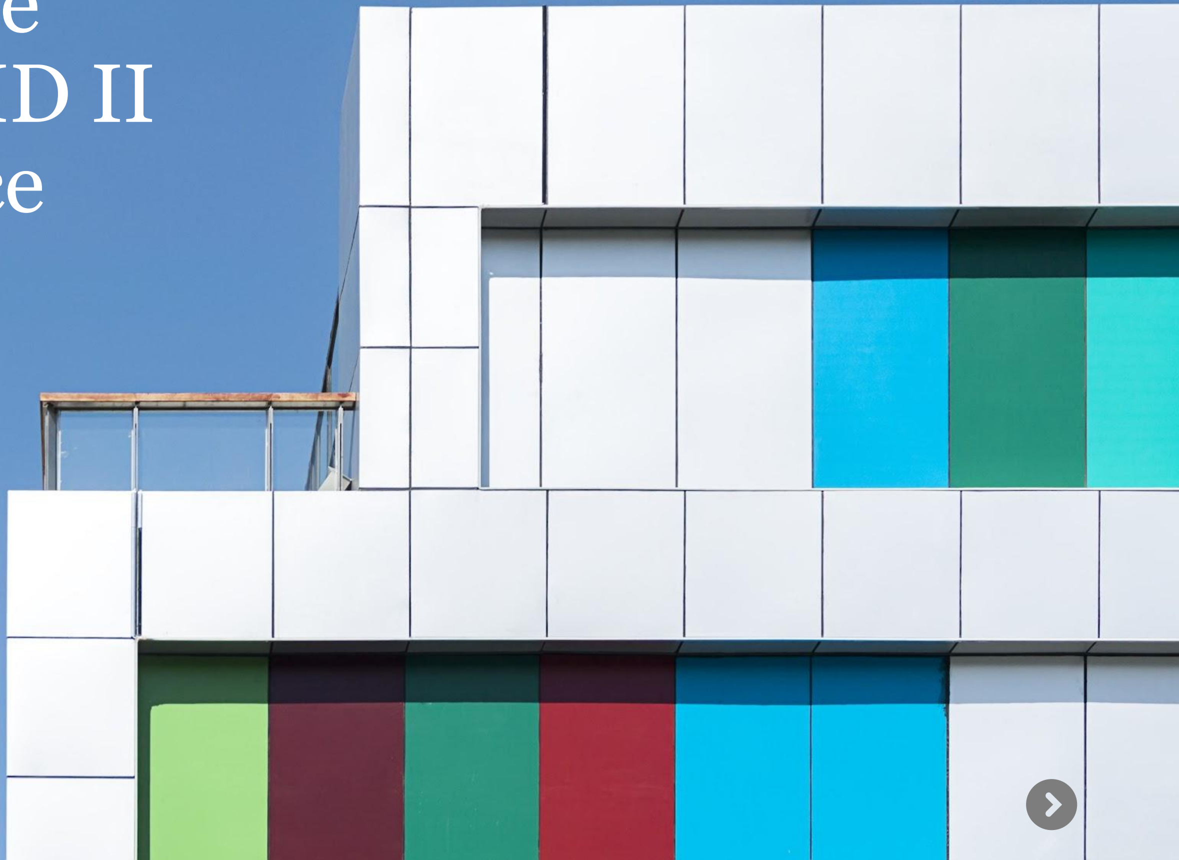
ESMA review of the guidelines on MiFID II product governance requirements

July 2022



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Introduction

On 8 July 2022, ESMA published a Consultation Paper (CP) detailing guidelines on certain aspects of the MiFID II product governance requirements which have been reviewed, taking into account the following recent regulatory and supervisory developments:

- The European Commission's Capital Markets Recovery Package and subsequent Amending Directive;
- The sustainability related amendments to the MiFID II Delegated Directive;
- the recommendations on the product governance guidelines by ESMA's Advisory Committee on Proportionality (ACP); and
- The findings of ESMA's 2021 Common Supervisory Action on product governance.

The main proposal modifications by ESMA address the following parts of the guidelines:

- **Definitions:** Updated to consider the exemptions introduced to the product governance requirements based on the MiFID II Amending Directive under the following 2 areas.

  1. firms are exempted from the product governance requirements where the investment service relates to bonds with no other embedded derivative than a make-whole clause
  2. where the financial instruments are marketed or distributed exclusively to eligible counterparties.

- **Guidelines for manufacturers:** Integrate sustainability factors into the product governance obligations. This should be applied to the broader category of clients' objectives and needs. ESMA highlights the key factor in determining the level of granularity with which the target market should be identified, and consequently the product's level of complexity.
- **Guidelines for distributors:** When offering a certain product to a client, the distributor should not only take into account the nature of the product and the investment service under which it is to be distributed, but also how such a product will be distributed to the market. Firms should take responsibility to ensure the general consistency of the products and services that are going to be offered to clients and which products are to be offered under the different services. To ensure the proper scrutiny of complex products, distributors should determine as a result of the manufacturers target market description, if they need access the underlying assessments of the manufacturer's scenario and charging structure analysis.
- **Guidelines for manufacturers and distributors:** ESMA notes that for products which consider sustainability factors, firms are not required to identify a negative target market assessment in relation to any sustainability-related objectives. ESMA states that the rationale for this exemption is to ensure that products with sustainability factors remain easily available, including clients that do not have sustainability preferences.

The ESMA guidelines apply to the following categories of firms:

- MiFID investment firms ("MiFID firms") and credit institutions in the manufacturing or distribution of investment products;
- Investment firms and credit institutions when selling or advising clients in relation to structured deposits; and
- UCITS management companies (UCITS ManCos) and external Alternative Investment Fund Managers (AIFMs) when providing the investment services of individual portfolio management or non-core services.

The CP includes a list of questions ESMA poses to stakeholders and invites all stakeholders to make comments and describes any alternative actions ESMA should consider. The stakeholders can make comments until **7 October 2022.**

Guidelines for manufacturers

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

ESMA states that the manufacturers should take into account the following criteria when the potential target market is identified:

- The results of the scenario and charging structure analysis undertaken for the relevant product.
- Categories shouldn't be merged to identify the potential target market and should ensure the consistency between different categories.
- The decision to market or distribute a product exclusively to eligible counterparties should clearly be made ex-ante, based on the firm's internal processes.
- When the compatibility between the risk tolerance and the risk/reward profile of the product is being assessed, firms should take into account the relevant risks that may not be measured by the risk indicator. For example, the impact of currency risk on the target market.
- When the objectives and needs of the clients are being assessed, they should take into account the expected investment horizon holding period, duly considering the potential impacts for clients of an early exit.

To ensure a sufficient level of granularity of the target market when identifying sustainability-related objectives, firms may specify the following aspects:

1. The minimum proportion of the product that is invested in environmentally sustainable investments;
2. The minimum proportion of the product that is invested in sustainable investments;
3. Whether, where relevant, the product has a focus on either environmental, social or governance criteria or a combination of them;
4. Which principal adverse impacts (PAI) on sustainability factors are considered by the product, including quantitative or qualitative criteria demonstrating that consideration;
5. Firms could use the categories presented in the draft regulatory technical standards(RTS) of Sustainable Finance Disclosure Regulation (SFDR) (instead of an approach based on each PAI indicator) such as emissions, energy performance, water and waste.

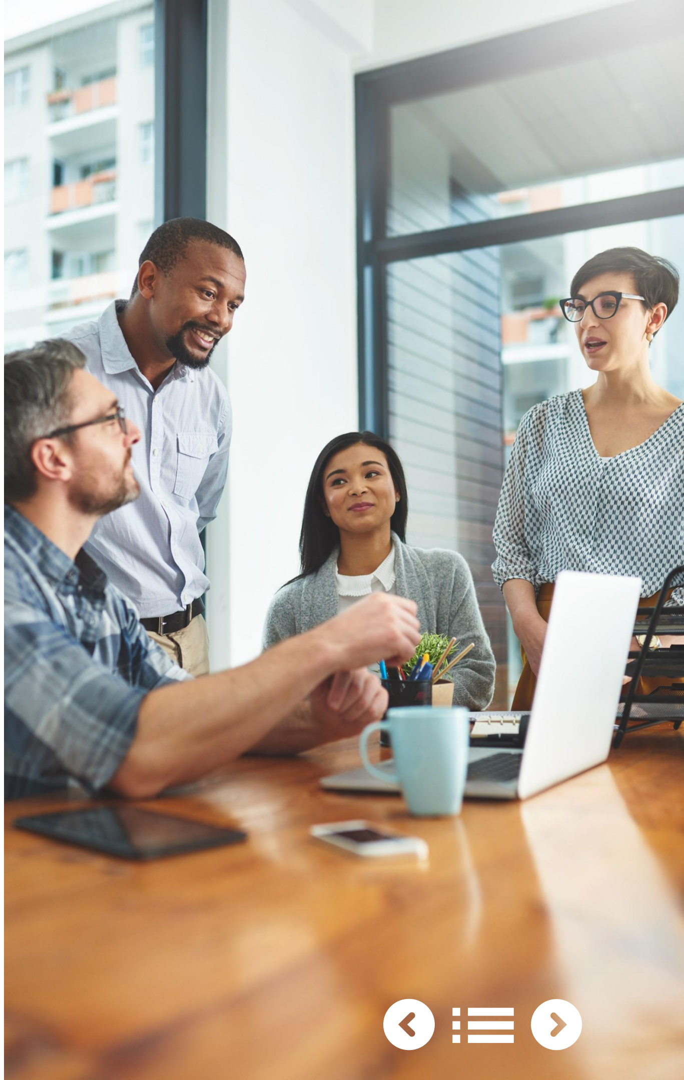
Guidelines for manufacturers

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

ESMA states that for manufacturers:

- The target market assessment should be made for all products, including certain simpler products distributed under the execution-only exemption, applying a proportionality approach. A clustering approach could also be adopted.
- Should define and adequately graduate the level of complexity to be attributed to manufactured products to determine the necessary level of detail with which the target market should be identified.
- For complex and risky products such as a contract for difference (CFD) a very detailed target market assessment is required. Complex products should only be marketed to clients who have the required product knowledge and are aware of the risks involved with the complex product and are seeking speculative investments with only a small chance of earning positive returns.
- When a clustering approach is used to identify the target market, firms should consider multiple key factors including:
    - Risk factors (such as market, credit and liquidity risk);
    - Charging structure (level and type of costs);
    - Optionality elements (in case of derivatives, or products with embedded derivatives);
    - Financial leverage;
    - Eligibility to bail-in;
    - Subordination clauses;
    - Use of unfamiliar or opaque indices;
    - Guarantees of principal repayment or capital protection clauses;
    - Liquidity of the product such as tradability on trading venues, bid-ask spread, selling restrictions, exit charges;
    - and the currency denomination of the product.

Moreover, using a clustering approach does not relieve firms of the obligation to check and document each individual product, ensuring it fits the criteria of a certain cluster and whether it can be assigned the predetermined target market for this cluster.



Guidelines for distributors

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

The offering of a certain product in the interest of the client does not only depend on the nature of the product and the investment service under which it is to be distributed, but how such a product will be distributed. Certain aspects of a firm's proposition can add complexity and risks to a product that in itself would be considered as relatively simple.

An example would be a firm that uses active marketing strategies involving behavioural finance, gamification techniques, or facilitates margin trading in relation to a share. Such practices add complexity and risks that are relevant in determining the target market that the products and services are compatible with.

Firms should take responsibility to ensure the general consistency of the products and services that are offered to clients, and which products are offered under the different services. In this context, firms should also assess whether its investment and/or ancillary services are compatible with the needs, characteristics and objectives of its existing clients or potential clients.

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

ESMA states for distributors:

- Should avoid merging two or more categories when the target market is defined.
- Should identify the actual target market for their products. They should review and refine the manufacturer's potential target market based on the information they have about their clients or potential clients.
- The 2021 CSA showed that firms sometimes only rely on the 'outcome' of the manufacturer's target market assessment for this refinement, without having access to the underlying or related documents that were used by the manufacturer in determining the target market for a given product. ESMA believes that firms should determine whether they need access to underlying documents such as the outcomes of the manufacturer's scenario and charging structure analyses.
- ESMA found that firms using a clustering approach sometimes identify clusters for UCITS in too broad a manner, resulting in grouping together insufficiently homogeneous products (e.g. grouping all UCITS equity funds into the same cluster). The firm should ensure that only UCITS with sufficiently comparable characteristics are clustered for the purposes of the target market identification, differentiating factors are the types of asset classes the UCITS invests in, its investment strategy, risks, charging structure and any leverage used. These factors should be used in a cumulative manner.

Guidelines for distributors

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

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, to ensure the compatibility between that product and the respective target clients. This obligation should apply in a proportionate manner depending, not only on the nature of the product but on the type of investment services that the firm provides.

This decision should always be based on the consideration of the product's features, as well as on other relevant situations (such as the occurrence of conflicts of interest in case of self-placement or inducements). Therefore, products should not be distributed under non-advised sales if the distributor cannot reasonably expect that the distribution strategy for the product (including its marketing and information strategy) will generally enable the product to reach the identified target market.

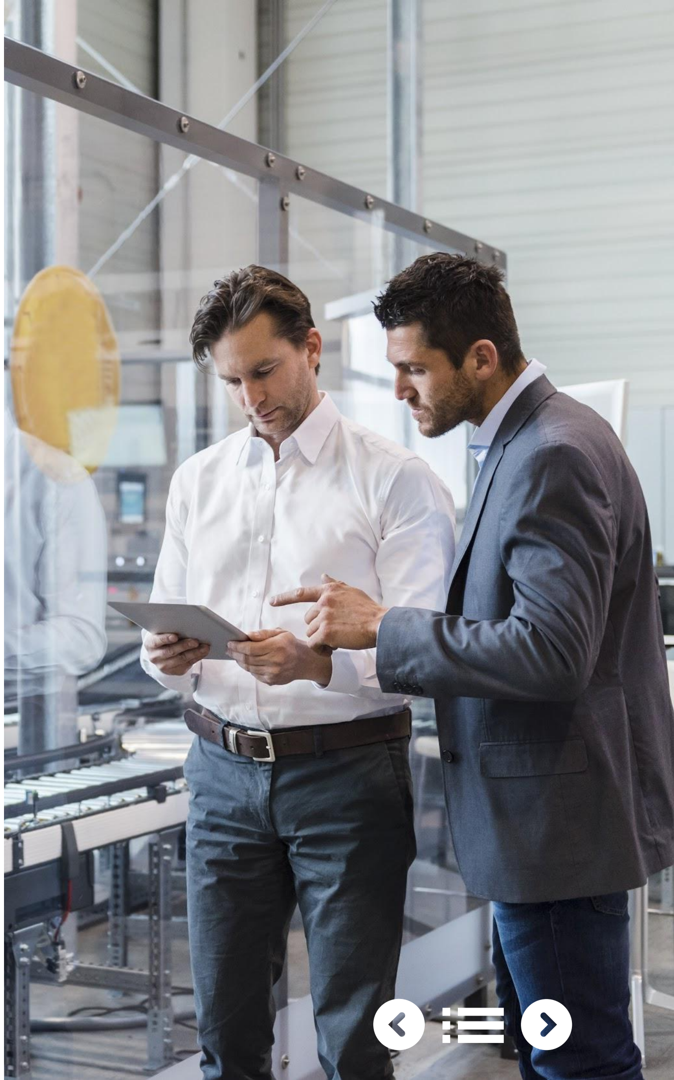
Providing a warning that the firm is not in the position to assess a client's full compatibility with a product does not exempt the firm from the obligation to review products, also taking into consideration any sales outside of the target market.

4. Distribution strategy of the distributor.

A key aspect enabling products to reach the identified target market is the requirement to specify a compatible distribution strategy for a product. ESMA proposes that when the distributor refines the distribution strategy and considers that a more complex product with a relatively narrow target market can also be distributed under non-advised services, it should identify additional measures to ensure that the distribution strategy is compatible with the product's target market. In such cases, distributors should consider aspects such as:

- What marketing strategy should be followed for the product (including active marketing, the use of behavioural finance and/or gamification techniques). For example, a distributor could decide to make a more complex product only available when requested by the client and not to actively market it or use any gamification techniques in the distribution of such a product to its clients;

- Whether and how the product should be displayed in the client's choice environment. For example, a distributor could decide not to show complex product on a prominent place on the website or at the top of a client's search results and could decide to show such a product only if the client specifically requests it.



Guidelines for distributors

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

ESMA proposes additional clarifications on the requirement to review products:

- Firms should use the following criteria relating to the product's characteristics
  - Changes in the product's risk factors;
  - Investment strategy;
  - Cost structure;
  - Market conditions (e.g. adverse market conditions, regulatory developments);
  - Distribution (such as client complaints, sales outside the target market, results from client surveys, online client trading behaviour).

- Firms should determine the frequency and depth of product reviews while taking into account the nature of the product and, where appropriate, the service. For example, for certain simpler products distributed under the execution-only regime, product reviews can be less frequent and require less depth, and ad-hoc reviews can to a large extent be driven by client complaints and/or market events that significantly affect the product's risk-return profile.

- To support reviews by MiFID manufacturers, distributors must provide relevant information proactively and not provide such information only at the manufacturer's request.

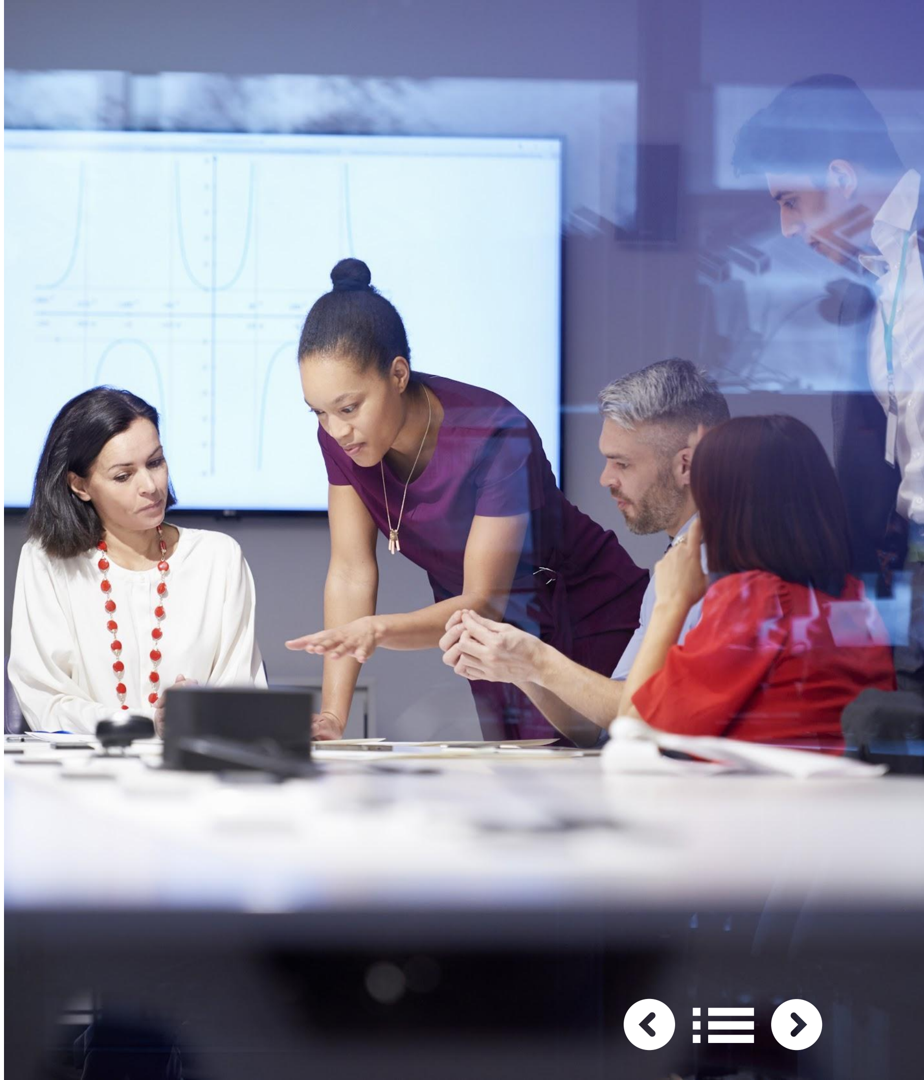
- Distributors are required to review products for as long as they are offered, sold or recommended. Where a distributor no longer offers, sells or recommends a product, the distributor is no longer obliged to review the target market of that product, despite that, a client may still have investments in the product. Where a distributor recommends to its clients, to hold a product it no longer offers or sell, it is still required to review the target market of that product.

Guidelines on issues applicable to both manufacturers and distributors

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

For products which consider sustainability factors, firms are not required to identify a negative target market with respect to their sustainability-related objectives. This means that the sustainability-related objectives of such products only contribute to identifying a positive target market in terms of clients with compatible sustainability preferences. Hence, for products which consider sustainability factors, the firm should always perform a negative target market assessment with respect to the five target market categories including client type, knowledge and experience, financial situation, risk tolerance and objectives and needs, but should not consider the sustainability-related objectives of the products.

ESMA states that the rationale of this negative target market exemption is to ensure that products with sustainability factors remain easily available for clients that do not have sustainability preferences.



What do firms need to do?

All impacted MiFID firms and UCITS ManCos and AIFMs, when providing the investment services of individual portfolio management or non-core services, **should review their product governance frameworks**.

In particular, the reviews performed by impacted firms should:

1. **Refocus on target market assessments, and governance, and consider:**

    - The level of granularity with which a product is being considered as complex or non complex;
    - The level of granularity with which the target market is being identified, if the target market assessment takes into account the complexity level of the product and the results of the scenario and charging structure analyses;
    - Integrate the sustainability factors in the client's objectives and needs category to identify the target market;
    - Review the target market assessment to products clustered.

2. **Review their product governance processes** to ensure that the firm is considering the relevance of ESMA latest proposed guidelines to their own approach.

How can we help?

01

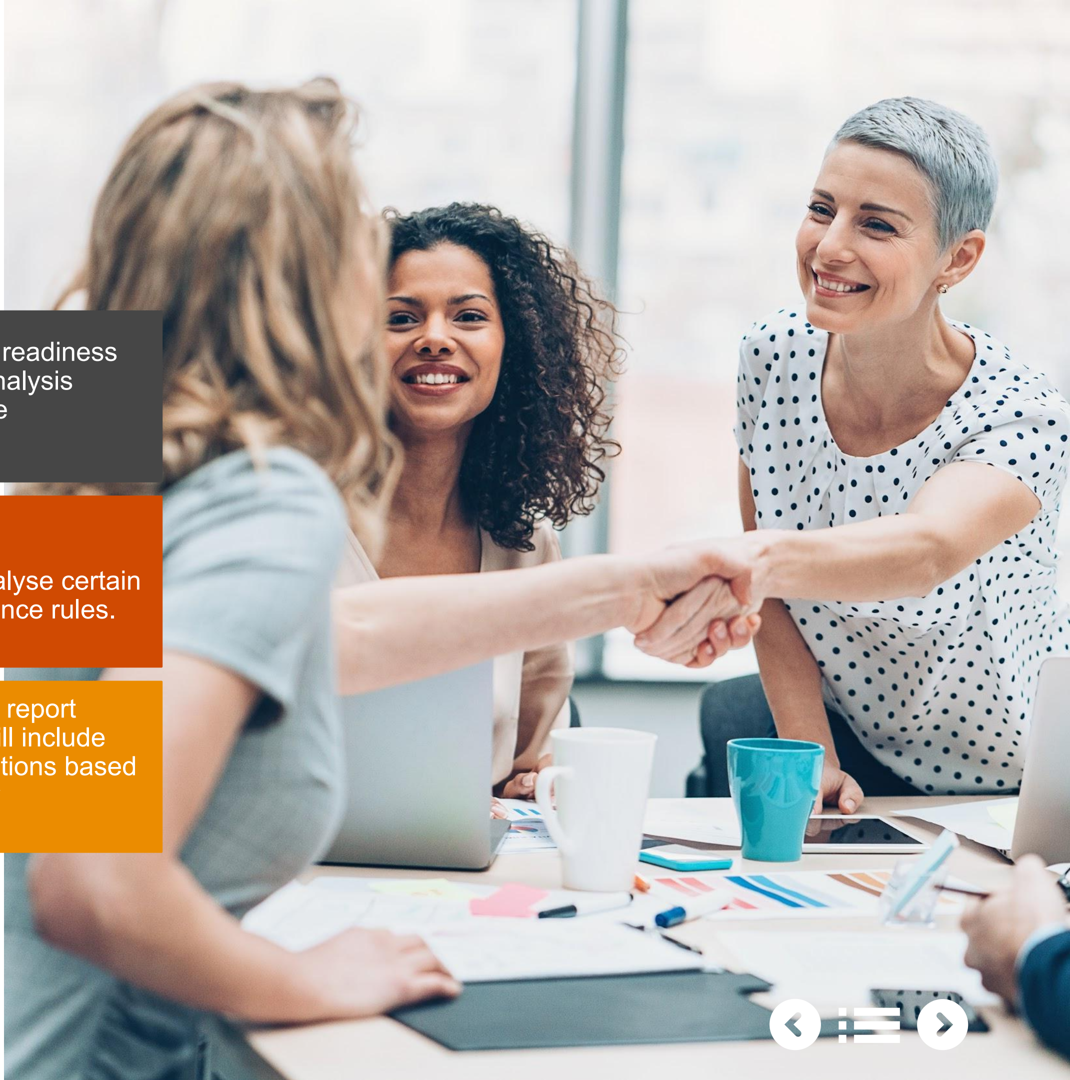
Perform a product governance readiness assessment, involving a gap analysis against the product governance requirements.

02

Perform a product governance thematic/targeted review to analyse certain aspects of the product governance rules.

03

Produce a product governance report based on our analysis which will include observations and recommendations based on best practice and regulatory requirements.



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