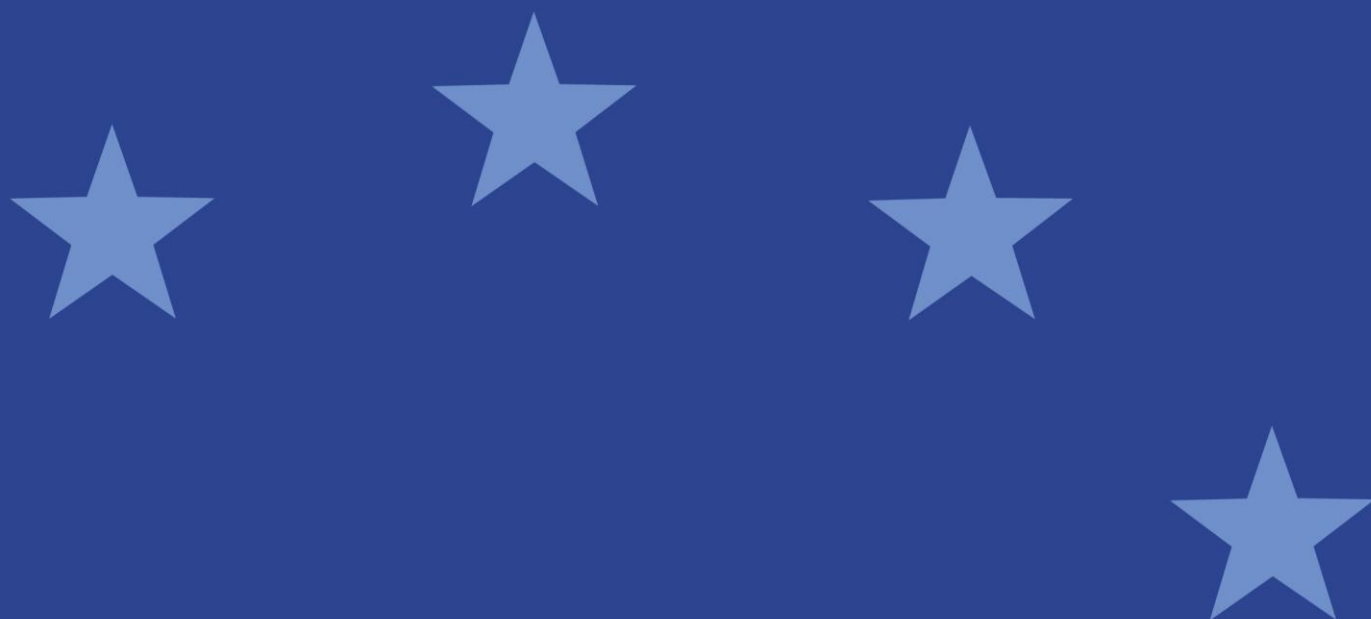


# Consultation Paper

**Review of the Guidelines on MiFID II product governance requirements**



## **Responding to this paper**

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

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

ESMA will consider all comments received by **7 October 2022**.

All contributions should be submitted online at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading 'Your input - Consultations'.

### **Publication of responses**

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

### **Data protection**

Information on data protection can be found at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading '[Data protection](#)'.

### **Who should read this paper?**

This paper is primarily of interest to competent authorities, firms that are subject to Directive 2014/65/EU on Markets in Financial Instruments (MiFID II) and investors.

## Table of Contents

|     |                                                                                                                        |    |
|-----|------------------------------------------------------------------------------------------------------------------------|----|
| 1   | Executive Summary .....                                                                                                | 4  |
| 2   | Background.....                                                                                                        | 5  |
| 2.1 | Overview .....                                                                                                         | 5  |
| 2.2 | Approach taken .....                                                                                                   | 5  |
| 3   | Annexes .....                                                                                                          | 19 |
| 3.1 | Annex I - Summary of questions.....                                                                                    | 19 |
| 3.2 | Annex II - Cost-benefit analysis .....                                                                                 | 21 |
| 3.3 | Annex III – Draft Guidelines.....                                                                                      | 24 |
| 3.4 | Annex IV – Good practices.....                                                                                         | 47 |
| 3.5 | Annex V - Illustrative examples and case studies related to the application of certain aspects of the guidelines ..... | 49 |
| 3.6 | Annex VI – ACP Advice on Proportionality of the ESMA Product Governance Guidelines.....                                | 57 |

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# 1 Executive Summary

## Reasons for publication

The product governance requirements introduced by MiFID II have proved to be one of the most important elements of the MiFID II investor protection framework, aiming at ensuring that financial instruments and structured deposits (“products”) are only manufactured and/or distributed when this is in the interest of clients. In accordance with Article 16(3) and 24(2) of MiFID II, firms that manufacture products for sale to clients or distribute products to clients shall maintain, operate and review adequate product governance arrangements. As part of these arrangements, a target market of end clients shall be identified and periodically reviewed for each product, as well as a distribution strategy that must be consistent with the identified target market. The MiFID II product governance requirements should ensure that firms act in their clients’ best interests during all stages of the product’s life cycle.

In accordance with Article 16(2) of the ESMA Regulation, this Consultation Paper (CP) sets out for consultation draft ESMA guidelines on certain aspects of the MiFID II product governance requirements. This CP builds on the text of the 2017 ESMA guidelines, 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. By pursuing the objective of ensuring a consistent and harmonised application of the product governance requirements, the proposed guidelines will make sure that the objectives of MiFID II can be efficiently achieved. ESMA believes that the implementation of these guidelines will strengthen investor protection, which is a key objective for ESMA.

## Contents

The background to the proposals is explained in section 2 of the CP, including the questions ESMA poses to stakeholders. A complete list of all questions posed is provided in Annex I. Annex II includes the draft cost-benefit analysis. The full text of the draft guidelines is included in Annex III and a draft list of good practices is included in Annex IV. Annex V contains a list of illustrative examples and case studies related to the application of certain aspects of the guidelines. Lastly, the ACP advice on ESMA’s product governance guidelines is provided in Annex VI.

## Next Steps

ESMA will consider the responses received to this consultation in Q4 2022 and expects to publish a final report, and final guidelines, in Q1 2023.

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## 2 Background

### 2.1 Overview

5. MiFID II<sup>1</sup> introduced product governance requirements for firms that manufacture and distribute financial instruments and structured deposits (“products”). These requirements have proved to be a key element of the MiFID II investor protection framework, requiring firms that manufacture or distribute products to act in clients’ best interests during all stages of the life cycle of products or services. In accordance with Articles 16(3) and 24(2) of MiFID II and Articles 9 and 10 of the MiFID II Delegated Directive<sup>2</sup>, firms that manufacture products for sale to clients or distribute products to clients shall maintain, operate and review adequate product governance arrangements. As part of these arrangements, a target market of end clients shall be identified and periodically reviewed for each product, as well as a distribution strategy that must be consistent with the identified target market.
6. In June 2017, ESMA published its Guidelines on certain aspects of the MiFID II product governance requirements<sup>3</sup> (“guidelines”), mainly providing guidance on the target market assessment, as this aspect was considered as the most relevant one for ensuring a common, uniform and consistent application of the product governance requirements.
7. While the guidelines remain relevant, several recent regulatory and supervisory developments have prompted a review of the guidelines:
  - the Commission’s Capital Markets Recovery Package and subsequent MiFID II Amending Directive;<sup>4</sup>
  - 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 (“CSA”) on product governance.

### 2.2 Approach taken

8. As mentioned above, the review takes four different elements into account. These are explained in more detail below.

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<sup>1</sup> Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014.

<sup>2</sup> Commission Delegated Directive (EU) 2017/593 of 7 April 2016.

<sup>3</sup> ESMA35-43-620.

<sup>4</sup> Apart from the proposed changes to MiFID II, the EC’s Capital Market Recovery Package also encompasses proposals of amendments to the Prospectus Regulation and the Securitisation Regulation, see also: [https://ec.europa.eu/info/publications/200722-proposal-capital-markets-recovery\\_en](https://ec.europa.eu/info/publications/200722-proposal-capital-markets-recovery_en)

### The EC's Capital Markets Recovery Package and subsequent Amending Directive

9. On 24 July 2020, the European Commission adopted the Capital Markets Recovery Package ("Recovery Package") to support the recovery from the severe economic shock caused by the COVID-19 pandemic.<sup>5</sup> The Recovery Package contains proposals for amendments to several regulatory frameworks in financial services, including MiFID II. In this context, the proposals also cover the product governance rules. On 26 February 2021, Directive 2021/338/EU ("MiFID II Amending Directive") was published and entered into force on the day following that of its publication.<sup>6</sup>
10. The MiFID II Amending Directive introduces two exemptions from the product governance requirements: i) where a firm provides an investment service relating to bonds with no other embedded derivative than a make-whole clause; and ii) where the financial instruments are marketed or distributed exclusively to eligible counterparties (ECPs). ESMA has updated the guidelines taking these exemptions into account. The relevant amendments mainly concern the definitions section and the guidelines on the application of the requirements in wholesale markets.

### Sustainability-related amendments to the MiFID II Delegated Directive

11. In March 2018 the Commission published its Action Plan 'Financing Sustainable Growth', setting up an ambitious and comprehensive strategy on sustainable finance.<sup>7</sup> Subsequently, the MiFID II Delegated Directive has been updated to integrate sustainability factors into the product governance obligations. The amendments have been published in the Official Journal of the European Union on 2 August 2021 and will apply from 22 November 2022. They are part of a broader Commission's initiative on sustainable development and lay the foundation for an EU framework which puts sustainability considerations at the heart of the financial system to support transforming Europe's economy into a greener, more resilient and circular system in line with the European Green Deal<sup>8</sup> objectives.
12. According to the MiFID II Delegated Directive, in summary, manufacturers and distributors are required to specify, as part of the target market assessment, any sustainability-related objectives the product is compatible with. Such objectives must also be covered by the periodic review obligation. Firms are not required to perform a negative target market assessment in relation to any sustainability-related objectives identified for a product.
13. The sustainability-related amendments to the MiFID II Delegated Directive have mainly led ESMA to propose amendments in the guidelines covering the target market categories to be considered and the negative target market assessment.

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<sup>5</sup> [https://ec.europa.eu/info/publications/200722-proposal-capital-markets-recovery\\_en](https://ec.europa.eu/info/publications/200722-proposal-capital-markets-recovery_en).

<sup>6</sup> Directive 2021/338/EU of the European Parliament and of the Council of 16 February 2021.

<sup>7</sup> COM(2018) 97 final.

<sup>8</sup> COM(2019) 640 final.

### Recommendations on the product governance guidelines by the ACP

14. On 27 April 2022, ESMA's Advisory Committee on Proportionality (ACP) provided its advice on ESMA's product governance guidelines to ESMA (see Annex VI). The ACP's recommendations have been considered in ESMA's review of the guidelines, for example, in relation to the additional guidance proposed on the clustering approach and on the application of the proportionality principle when performing product reviews.

### Findings of ESMA's 2021 Common Supervisory Action on product governance

15. In 2021, ESMA conducted a common supervisory action (CSA) on the MiFID II product governance requirements. 26 NCAs participated in this coordinated review, covering a total of 214 firms. As ESMA explained in its statement presenting the results of the 2021 CSA<sup>9</sup>, this exercise revealed that there was room for improvement in firms' compliance with several aspects of the product governance requirements. Where relevant, such aspects have been addressed in reviewing the guidelines, for example by providing more guidance on how firms should specify a compatible distribution strategy, on product reviews, and on the exchange of information between manufacturers and distributors.

16. The proposals are explained and summarised in the following paragraphs.

17. In order to facilitate the analysis of the proposed changes to the guidelines, when a paragraph in Annex III (Draft Guidelines) includes proposed amendments to the existing guidelines, the whole paragraph has been underlined (i.e., only underlined paragraphs have been amended, either partially or in their entirety). The non-underlined paragraphs of the guidelines have remained unchanged and the existing paragraphs for which a deletion has been proposed have been replaced by the following reference: [...].

### Definitions

18. The definitions have been updated considering the exemptions introduced to the product governance requirements based on the MiFID II Amending Directive. According to Article 16a of MiFID II, 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 or where the financial instruments are marketed or distributed exclusively to eligible counterparties.

19. ESMA already provided guidance on the perimeter of the exemption of bonds with no other embedded derivative than a make-whole clause in Q&A 16.5 of its Q&As on MiFID II investor protection and intermediaries topics.<sup>10</sup> ESMA also wishes to highlight that this exemption should not be used by firms as a means to circumvent the product governance requirements, e.g. by introducing a make-whole clause to bonds not embedding another derivative for the purposes of avoiding having to comply with the product governance requirements.

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<sup>9</sup> ESMA 35-43-3137.

<sup>10</sup> [esma35-43-349\\_mifid\\_ii\\_qas\\_on\\_investor\\_protection\\_topics.pdf\(europa.eu\)](https://esma35-43-349_mifid_ii_qas_on_investor_protection_topics.pdf(europa.eu)).

## General

20. ESMA proposes adding new paragraph 13 of the draft guidelines clarifying that firms should substantiate and document choices made in the context of their product governance arrangements. This clarification is suggested based on the outcomes of the 2021 CSA, which showed that firms often provide limited or no explanation on relevant choices made, such as the choices made in determining the compatible distribution strategy for the product and the way in which the firm will monitor whether a product is reaching the intended target market.

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

21. In paragraph 14 of the draft guidelines, ESMA suggests clarifying that, for the purposes of the target market identification, manufacturers should also take into account the results of the scenario and charging structure analyses undertaken for the relevant product. This suggestion is related to one of the findings of the 2021 CSA, showing that it is often unclear how manufacturers use the results of the scenario and charging structure analyses in their target market assessment. In ESMA's view, while being separate exercises, the outcomes of such analyses for a given product should be used in performing the target market assessment for this product. For example, the scenario analyses performed by the firm may reveal that a product's value is particularly sensitive to negative market conditions, leading to the identification of a narrower target market in terms of clients' risk tolerance. As another example, the charging structure analysis performed by the firm may reveal that the charging structure of the product is not compatible with the identified target market, leading the firm to modify the charging structure of the product and/or reassess the target market.

22. The 2021 CSA furthermore revealed that some firms merged certain target market categories when identifying the target market (e.g. specifying clients' financial position and risk tolerance as one category). This could result in insufficiently considering the different categories. Paragraph 16 of the draft guidelines is proposed to be updated against this backdrop.

23. Also based on the outcome of the 2021 CSA, ESMA proposes several clarifications in the guidance on the target market categories:

- ESMA proposes keeping the reference to ECP's in the guidance on the category type of client (paragraph 19a of the draft guidelines), because the exemption included in Article 16a of MiFID II refers to products marketed or distributed exclusively to ECPs. As certain products' target markets that include ECPs, may also include professional clients and/or retail clients, ESMA believes that this reference should be kept. ESMA also proposes clarifying that 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.
- In relation to clients' risk tolerance, several firms appeared to limit this assessment to a reference to the PRIIPs summary risk indicator, meaning that, where relevant, other risks not captured by this indicator would not be assessed. An example would be to

consider a product's currency risk for products issued in a currency other than the reference currency of the identified target market. ESMA proposes a clarification to paragraph 19d of the draft guidelines to address this issue.

- Regarding the specification of clients' objectives and needs, the existing guidelines clarify that firms could specify the expected investment horizon for a product. However, based on supervisory experience, ESMA considers that a firm should always specify this key aspect when determining the target market's objectives and needs a product is compatible with. This is proposed to be clarified in paragraph 19e of the draft guidelines.

**Q1: Do you agree with the suggested clarifications on the identification of the potential target market by the manufacturer (excluding the suggested guidance on the sustainability-related objectives dealt with in Q2)? Please also state the reasons for your answer.**

24. The sustainability-related amendments introduced to the MiFID II Delegated Directive require manufacturers and distributors to specify, as part of the target market assessment, any sustainability-related objectives the product is compatible with. ESMA proposes the addition of new paragraph 20 of the draft guidelines to clarify that firms should identify sustainability-related objectives as part of the target market assessment. In ESMA's view, this should be done within the broader category of clients' objectives and needs.
25. In particular, the paragraph suggests the possibility to align the definition of "sustainability-related objectives" with the definition of "sustainability preferences" according to Article 2(7) of the MiFID II Delegated Regulation and as further detailed in the ESMA Guidelines on certain aspects of the MiFID II suitability requirements. The current wording aims indeed to align the paragraphs as much as possible with the relevant paragraphs of the ESMA suitability guidelines that are currently under review; as a consequence, this is subject to any final decision that will be taken in relation to the ESMA suitability guidelines<sup>11</sup>. This suggested approach aims to facilitate firms' implementation in different roles and in different stages of the product cycle (manufacturing and/or distribution). Due to the importance of this topic, ESMA welcomes any views that stakeholders may have on this.
26. When identifying the target market for products with sustainability factors, ESMA expects firms to consider the elements listed in paragraph 20 of the draft guidelines. ESMA acknowledges that, depending on the type of product with sustainability factors, one or more of the elements listed in paragraph 20 of the draft guidelines may not be relevant. Even though the term 'minimum proportion' is derived from the SFDR and the Taxonomy Regulation<sup>12</sup>, ESMA notes that in the MiFID context, it should be read in a broad sense (i.e. possibly also applying to products with sustainability factors that are not in scope of the SFDR and/or the Taxonomy Regulation). In this respect, ESMA would like to receive input

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<sup>11</sup> ESMA35-43-2998

<sup>12</sup> Regulations (EU) 2019/2088 and 2020/852 of the European Parliament and of the Council.

from stakeholders on whether there are categories of financial instruments for which the reference to “minimum proportion” would not be possible<sup>13</sup>.

27. ESMA is aware that, when determining the potential target market, a manufacturer may specify sustainability-related objectives a product is compatible with by referring to the sustainability data (e.g. taxonomy alignment, KPIs concerning PAIs) of either i) the issuer of the product, or ii) the product itself (i.e. its underlying assets). In this respect, ESMA would like to receive input from stakeholders on whether there would be benefits to clarifying the circumstances under which either approach i) or approach ii) may be justified, for example in the case of structured products not covered by SFDR (e.g. EMTN). In that case, views are sought from stakeholders on the criteria which would make one approach more relevant than the other (e.g. non-packaged vs. packaged product, ‘use-of-proceed’ feature of the product, etc.).

28. Moreover, it should be noted that, in accordance with the level II requirements, sustainability-related objectives must also be covered by the periodic review obligation. Lastly, ESMA also refers to the proposed guidance on the negative target market assessment in relation to sustainability-related objectives in paragraph 81 of the draft guidelines, which is further explained below in paragraph 49.

**Q2: Do you agree with the suggested approach on the identification of any sustainability-related objectives the product is compatible with? Do you believe that a different approach in the implementation of the new legislative requirements in the area of product governance should be taken? Please also state the reasons for your answer.**

**Q3: What are the financial instruments for which the concept of minimum proportion would not be practically applicable? Please also state the reasons for your answer.**

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

29. The 2021 CSA showed that not all firms perform a target market assessment for all products manufactured or distributed. For example, such firms did not perform a target market assessment for certain simpler products to be distributed under the execution-only exemption. This is an obvious non-compliant practice as the product governance requirements apply to all products manufactured or distributed. A clarification has been proposed in this respect to paragraph 23 of the draft guidelines. Still, ESMA notes that the application of the product governance requirements must be subject to proportionality, meaning that, for example, the target market for certain simpler products distributed under the execution-only exemption can be identified with less detail. Moreover, firms could also adopt a clustering approach in such cases (see the explanation provided below).

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<sup>13</sup> The concept of “minimum proportion” does not apply to financial instruments for which it is not practically possible to define such minimum proportion (for instance bonds or shares, etc.). These types of products could refer to the actual proportion instead of the minimum one.

30. A key factor in determining the level of granularity with which the target market should be identified, and consequently, in determining the perimeter of the target market, is the product's level of complexity. The 2021 CSA however showed that several firms did not adequately define and consider the product's level of complexity and oftentimes only categorised products for this purpose based on the difference between complex and non-complex products as defined in Article 25(4) of MiFID II. ESMA stresses that a proper definition and graduation of the level of complexity of products is a necessary precondition to enable the firm to adequately determine the level of detail with which the target market should be identified. Moreover, while Article 25(4) of MiFID II contains relevant criteria and principles for determining a product's level of complexity, in ESMA's view, firms should not solely rely on the dichotomy between complex and non-complex products for the purposes of the target market assessment and should determine what factors make a product more or less complex (for example by considering its charging structure or its underlying assets). Paragraph 24 of the draft guidelines is proposed to be updated to address these points.
31. The target market and distribution strategy assessment, as well as the product governance requirements in a broader sense aim at preventing mis-selling of products. Considering that this mis-selling risk is especially pronounced for more complex and risky products, the target market and distribution strategy assessment should be most diligent for such products. Indeed, because of their particularly complex and risky nature, certain products, such as contracts for difference (CFDs) or products with similar characteristics, only have a very narrow compatible target market, or no compatible target market at all. This principle should be reflected in the outcome of firms' target market assessments for such products. Paragraph 26 of the draft guidelines is proposed to clarify this.
32. The 2021 CSA showed that firms often identify the target market per cluster of products rather than per individual product. The existing guidelines already allowed for the use of such a clustering approach provided that the financial instruments belonging to a certain cluster have sufficiently comparable product features. In practice, however, the 2021 CSA revealed that firms tend to use significantly varying levels of granularity when clustering products for the purposes of the target market assessment, sometimes resulting in too broad clusters containing financial instruments with insufficiently comparable product features. This investor protection risk has also been identified by the ACP, which points to the recurring difficulty when products of too different profiles are put in the same cluster. The ACP thus recommends that the clustering approach is considered for further elaboration in the guidelines.
33. Against this backdrop, ESMA proposes expanding the guidance on the clustering approach in paragraphs 27-29 of the draft guidelines. ESMA considers that firms may use a clustering approach for both simpler and more complex products (for example for certain standardised exchange traded derivatives). It is however key that firms use a sufficient level of granularity when clustering products, considering the level of complexity included in a cluster. Generally speaking, this will mean that the more complex the underlying products of a cluster become, the more granular the clustering should be. Moreover, for certain more complex products, such as certain OTC derivatives or structured products, it is expected that a clustering approach will not be appropriate and that firms should define the target market at the level of the individual product.

34. In order to ensure an appropriate level of granularity, ESMA proposes including a non-exhaustive list of multiple key factors that should be considered when defining the clusters. Such factors should be considered in a cumulative manner. Moreover, using a clustering approach does not relieve firms of the obligation to check and document for each individual product whether it fits the criteria of a certain cluster and thus whether it can be assigned the pre-determined target market for this cluster. Importantly, the clustering approach aims at facilitating firms' application of the product governance requirements but should not be seen as an exception to the obligation to define a target market and distribution strategy for each product. For example, where a firm manufactures/distributes a certain fixed-income product, it should check whether the product satisfies the criteria for the relevant cluster for such fixed-income products (e.g. in terms of credit rating, duration, currency denomination, and so on). Such a check should be documented by firms.

**Q4: Do you agree with the suggested guidance on complexity in relation to the target market assessment and the clustering approach? Please also state the reasons for your answer.**

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

35. The target market and distribution strategy assessment should ensure that products are only offered when in the interest of the client. This requirement applies to all products manufactured or distributed, while subject to the proportionality principle, meaning that, for example, the target market for a relatively simple product to be distributed under non-advised sales may be identified with less detail.

36. In ESMA's view, whether the offering of a certain product is 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 also on how such a product will be distributed. In particular, 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 or gamification techniques, or that facilitates margin trading in relation to a share. Such practices add complexity and risks that are relevant in determining the target market the products and services are compatible with. ESMA also identified this risk in its Final Report on the European Commission mandate on certain aspects relating to retail investor protection, published on 29 April 2022.<sup>14</sup>

37. In ESMA's view, 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. In this context, firms should also assess whether its investment and/or ancillary services are compatible with the needs, characteristics, and objectives of its clients or potential clients. This should include a consideration of the distribution strategies to be used for the different client groups, also covering the manner

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<sup>14</sup> [esma35-42-1227 final report on technical advice on ec retail investments strategy.pdf \(europa.eu\)](#).

in which products will be marketed to clients. ESMA proposes clarifications in paragraphs 34, 35 and 39 of the draft guidelines in this respect.

38. ESMA notes that this guidance on the assessment of the general consistency of the products and services to be offered to clients, including the distribution strategies used, is distinct from the guidance on the distribution strategy for a specific product as is proposed in paragraph 59 of the draft guidelines.

**Q5: Do you agree with the suggested guidance on the assessment of the general consistency of the products and services to be offered to clients, including the distribution strategies used? Please also state the reasons for your answer.**

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

39. Where manufacturers should identify the potential target market for their products, distributors should identify the actual target market for their products, i.e. reviewing and refining the manufacturer's potential target market based on the information they have about their clients or potential clients. The 2021 CSA revealed that firms have different approaches to this refinement exercise. In light of this, ESMA proposes adding an additional clarification on the practice of refinement to paragraph 42 of the draft guidelines. In this context, it is proposed to clarify that distributors should use consistent terms and definitions, and ensure consistency in the target markets defined for products with homogeneous characteristics, and with their point-of-sale arrangements (i.e. with the suitability and appropriateness assessments).
40. The 2021 CSA showed that firms sometimes only rely on the 'outcome' of the manufacturer's target market assessment for this refinement (i.e. the description of the target market as provided by the manufacturer), without having access to the underlying or related documents that were used by the manufacturer in determining the target market for a given product. This could be sufficient in case of some simpler products, but for more complex products, in order to perform a proper scrutiny, 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 proposes clarifying this in paragraph 46 of the draft guidelines.
41. The guidance on the clustering approach as proposed for manufacturers in paragraph 27-29 of the draft guidelines also applies to distributors. ESMA proposes clarifying this in paragraph 47 of the draft guidelines. In addition, an example is proposed regarding the identification of adequate clusters relating to UCITS. Reason being that the 2021 CSA revealed that firms using a clustering approach sometimes identify clusters for UCITS in a too broad manner, resulting in grouping together insufficiently homogeneous products (e.g. grouping UCITS all equity funds into the same cluster). The example proposed aims at clarifying that firms should use a sufficient level of granularity instead.

**Q6: Do you agree with the suggested guidance on the identification of the target market by the distributor? Please also state the reasons for your answer.**

#### Distribution strategy of the distributor

42. A key aspect enabling products to reach the identified target market is the requirement to specify a compatible distribution strategy for a product. The 2021 CSA showed that firms often limit this identification of the distribution strategy to the specification of the investment service or applicable point-of-sale regime under which the product should be distributed (e.g. advised versus non-advised sales, or the execution-only exemption). While this might be sufficient in some cases, for example where it concerns a relatively simple product with a relatively broad target market or where the firm restricts the distribution strategy for a product to advised sales only. In other cases such an approach will not be sufficient for determining a compatible distribution strategy. This would be the case, for example, when a firm considers that a relatively complex product with a relatively narrow target market can be distributed under non-advised sales. In such cases, ESMA considers that additional measures are necessary to ensure that the firm duly identifies a compatible distribution strategy that enables the product to reach the identified target market.
43. Against this backdrop, building on the requirement that the distributor should refine the manufacturer's target market, ESMA proposes clarifying in paragraph 59 of the draft guidelines that distributors should refine the distribution strategy as proposed by the manufacturer. Consistent with the proportionality principle, ESMA proposes that distributors should identify additional measures where they consider that a more complex product can be distributed under non-advised sales; in this context, aspects such as the marketing strategy and the client's choice environment should be considered.
44. Furthermore, in light of the guidance on the distribution strategy as proposed in paragraph 59 of the draft guidelines, ESMA proposes some additional clarifications on the possibility to let clients operate on a non-advised basis after having warned them that the firm is not in a position to assess their full compatibility with a product (paragraph 56 of the draft guidelines). In short, ESMA proposes clarifying that also in this case, products should not be distributed under non-advised sales if the distributor cannot reasonably expect that the product will generally reach the identified target market through this distribution strategy. Likewise, the distributor should perform periodic product reviews in such a case, and, in the context of these reviews, the distributor should also take into consideration any sales outside of the target market.

**Q7: Do you agree with the suggested approach on the determination of distribution strategy by the distributor? Please also state the reasons for your answer.**

#### Portfolio management, portfolio approach, hedging and diversification

45. The existing guidelines allow firms to deviate from the identified target market for a product when the product is used for diversification or hedging purposes when providing investment advice under a portfolio approach or portfolio management, provided that the portfolio or hedge is suitable for the client. Firms using this possibility should still comply with both the product governance and suitability requirements, as the product governance requirements apply irrespective of the point-of-sale requirements. Supervisory experience has shown

that some firms using this deviation possibility do not apply the relevant product governance requirements, such as performing a target market assessment for the product. Moreover, some firms appear to use the deviation possibility too broadly, for example in relation to the target market categories “type of client” and “clients’ knowledge and experience”. In ESMA’s view, a deviation from these categories cannot be justified for diversification or hedging purposes. This is proposed to be clarified in paragraph 64 of the draft guidelines<sup>15</sup>.

**Q8: Do you agree with the suggested approach on the deviation possibility for diversification or hedging purposes when providing investment advice under a portfolio approach or portfolio management? In particular, do you agree that a deviation from the target market categories “type of client” and “knowledge and experience” cannot be justified for diversification or hedging purposes, neither in the context of investment advice under a portfolio approach, nor portfolio management? Please also state the reasons for your answer.**

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

46. ESMA proposes various additional clarifications on the requirement to review products. The first considers the criteria to be used to review products. The 2021 CSA showed that in general firms use various criteria to review products, relating to the product characteristics, market conditions and distribution. However, practices tend to vary per firm and not all firms used all relevant criteria. For example, some firms did not include relevant information on sales outside of the target market. ESMA proposes clarifying in paragraph 70 of the draft guidelines that firms should use criteria relating to all three elements (product characteristics, market conditions and distribution) when reviewing products.
47. ESMA furthermore proposes clarifying the application of the proportionality principle when performing product reviews in line with the relevant recommendation by the ACP. In ESMA’s view, proportionality would be relevant in determining the frequency and depth of product reviews, which would mean that, for certain simpler products distributed under the execution-only regime, product reviews can be less frequent and would require less depth. This clarification is proposed in paragraph 70 of the draft guidelines. ESMA stresses, however, that all products manufactured or distributed should be subject to periodic reviews, irrespective of whether products are simpler or more complex.

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<sup>15</sup> In the case of portfolio management, given the specific nature of the service, it would normally be expected that the level of “clients’ knowledge and experience” of the target market can be less detailed. This is in line with the approach suggested in ESMA Guidelines on suitability where it is clarified that “(...) when portfolio management is to be provided, as investment decisions are to be made by the firm on behalf of the client, the level of knowledge and experience needed by the client with regard to all the financial instruments that can potentially make up the portfolio may be less detailed than the level that the client should have when an investment advice service is to be provided. Nevertheless, even in such situations, the client should at least understand the overall risks of the portfolio and possess a general understanding of the risks linked to each type of financial instrument that can be included in the portfolio. Firms should gain a very clear understanding and knowledge of the investment profile of the client”.

48. ESMA also proposes including additional guidance on the product review obligations applying to distributors only:

- In paragraph 73 of the draft guidelines, ESMA proposes clarifying that firms have the responsibility to provide relevant information to manufacturers to support their reviews, and should not only do so at the manufacturer's request. This clarification is intended to address the finding of the 2021 CSA that distributors often only passively provide such information to manufacturers.
- In paragraph 73 of the draft guidelines, ESMA suggests adding a sentence on the responsibility for distributors to determine, on an ex-ante basis, what information they need to consider in assessing whether products generally reach the intended target market. Firms may need to gather further information about their clients for this purpose, for example by asking additional questions to clients that have bought a product under non-advised services. This paragraph takes into account the outcome of the 2021 CSA.
- In paragraph 74 of the draft guidelines, ESMA suggests providing guidance on the duration of the distributor's requirement to review products, also considering the recommendation by the ACP that the guidelines could clarify the time limits of reviews in respect of products that were sold by the distributor in the past. MiFID II requires that distributors review products offered, recommended or sold. In ESMA's view, this means that 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 be invested in that product. ESMA also proposes addressing the specific situation in which a distributor issues a hold recommendation to a client in relation to a product that is no longer in its product offer but still included in the client's portfolio.

**Q9: Do you agree with the suggested approach on the requirement to periodically review products, including the clarification of the proportionality principle? Please also state the reasons for your answer.**

*Identification of the 'negative' target market and sales outside the positive target market*

49. According to Article 9 of the MiFID II Delegated Directive, firms shall identify, as part of the target market identification, any groups of clients with whose needs, characteristics and objectives the product is not compatible, except where the product considers sustainability factors. Consistent with the rationale of this exception of performing a negative target market assessment in relation to a product's sustainability-related objectives, ESMA proposes clarifying in paragraph 81 of the draft guidelines that, for products which consider sustainability factors, the firm should always perform a negative target market assessment with respect to the five target market categories (client type, knowledge and experience, financial situation, risk tolerance and objectives and needs), but should not consider the sustainability-related objectives of the products when performing such a negative target market assessment. Indeed, as clarified in Recital 7 of the MiFID II Delegated Directive, the rationale of this negative target market exemption is to ensure that products with



sustainability factors remain easily available also for clients that do not have sustainability preferences.

**Q10: Do you agree with the suggested approach on the negative target market assessment in relation to a product with sustainability factors? Please also state the reasons for your answer.**

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

50. As explained in paragraph 18 above, Article 16a of MiFID II exempts firms from the product governance requirements in relation to a product marketed or distributed exclusively to ECPs. ESMA proposes updating paragraph 89 of the draft guidelines and deleting paragraphs 80, 84 and 85 of the existing guidelines to take this exemption into account. In brief, ESMA proposes deleting the paragraphs on eligible counterparties as end clients, while keeping the references to ECPs as part of the intermediation chain as these would remain relevant.

**Q11: Do you agree with the suggested updates on the application of the product governance requirements in wholesale markets? Please also state the reasons for your answer.**

*Annex with good practices*

51. Based on NCAs' supervisory experiences with firm's compliance with the product governance requirements, also in the context of the 2021 CSA, ESMA proposes including a list of good practices showing how firms apply the product governance requirements in practice. ESMA expects that such examples will help firms comply with the relevant requirements. As explained before, the 2021 CSA also revealed several areas for which there was room for improvement in the application of the product governance requirements by firms. However, ESMA has chosen to only include good practices in Annex IV because it believes that such examples will be most helpful for firms in complying with the product governance requirements.

**Q12: Do you have any comment on the suggested list of good practices? Please also explain your answer.**

Case study on options

52. ESMA proposes adding a case study on options, which are more complex and risky products that can have different forms and can be used in different strategies. The case study is also proposed to illustrate how firms can choose a compatible distribution strategy for such products.

**Q13: Do you have any comment on the suggested case study on options? Please also explain your answer.**

## **3 Annexes**

### **3.1 Annex I - Summary of questions**

**Q1: Do you agree with the suggested clarifications on the identification of the potential target market by the manufacturer (excluding the suggested guidance on the sustainability-related objectives dealt with in Q2)? Please also state the reasons for your answer.**

**Q2: Do you agree with the suggested approach on the identification of any sustainability-related objectives the product is compatible with? Do you believe that a different approach in the implementation of the new legislative requirements in the area of product governance should be taken? Please also state the reasons for your answer.**

**Q3: What are the financial instruments for which the concept of minimum proportion would not be practically applicable? Please also state the reasons for your answer.**

**Q4: Do you agree with the suggested guidance on complexity in relation to the target market assessment and the clustering approach? Please also state the reasons for your answer.**

**Q5: Do you agree with the suggested guidance on the assessment of the general consistency of the products and services to be offered to clients, including the distribution strategies used? Please also state the reasons for your answer.**

**Q6: Do you agree with the suggested guidance on the identification of the target market by the distributor? Please also state the reasons for your answer.**

**Q7: Do you agree with the suggested approach on the determination of distribution strategy by the distributor? Please also state the reasons for your answer.**

**Q8: Do you agree with the suggested approach on the deviation possibility for diversification or hedging purposes when providing investment advice under a portfolio approach or portfolio management? In particular, do you agree that a deviation from the target market categories “type of client” and “knowledge and experience” cannot be justified for diversification or hedging purposes, neither in the context of investment advice under a portfolio approach, nor portfolio management? Please also state the reasons for your answer.**

**Q9: Do you agree with the suggested approach on the requirement to periodically review products, including the clarification of the proportionality principle? Please also state the reasons for your answer.**

**Q10: Do you agree with the suggested approach on the negative target market assessment in relation to a product with sustainability factors? Please also state the reasons for your answer.**



**Q11: Do you agree with the suggested updates on the application of the product governance requirements in wholesale markets? Please also state the reasons for your answer.**

**Q12: Do you have any comment on the suggested list of good practices? Please also explain your answer.**

**Q13: Do you have any comment on the suggested case study on options? Please also explain your answer.**

## 3.2 Annex II - Cost-benefit analysis

53. The product governance requirements are an essential element of the MiFID II investor protection framework and aim at ensuring that products are only manufactured or distributed when this is in the interest of clients.
54. These draft guidelines aim to ensure a common, uniform and consistent implementation of the MiFID II product governance requirements. As explained in the background section, several recent regulatory and supervisory developments necessitated a review of the existing guidelines to ensure that this aim can continue to be realised.
55. By providing clarification of the relevant MiFID product governance requirements, including on the new requirements on sustainability, ESMA is helping firms to improve their implementation of these requirements and play a role in ensuring an efficient implementation of EU framework which puts sustainability considerations at the heart of the financial system to support transforming Europe's economy into a greener, more resilient and circular system in line with the European Green Deal objectives. The draft guidelines also aim to ensure a convergent approach in the supervision of the product governance requirements. Greater convergence leads to improved investor protection (consumer outcomes), which is a key ESMA objective.

### The impacts of the draft ESMA guidelines

56. In light of the main objectives of these draft guidelines (extensively illustrated in the background section), the following preliminary assessment aims at explaining the benefits and costs of the key policy choices that are presented for consultation.
57. It should be preliminary observed that since product governance requirements are provided under MiFID II and the relevant Delegated Directive, the impact of the proposed guidelines should be considered having in mind 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 improved compatibility between products and the needs, objectives and characteristics of clients. The proposed guidelines should also facilitate competent authorities' efforts to improve the overall compliance with MiFID requirements increasing the investor confidence in the financial markets, which is considered necessary for the establishment of a genuine single capital market.
58. Finally, it is important to remind that those existing 2017 guidelines which are confirmed should not imply any additional impacts/costs for both firms and NCAs.

### Benefits

59. It is possible to illustrate the main benefits linked to the proposed guidelines as follows:
- reduction of the mis-selling risk and its related financial consequences. This is a major benefit for investors and for the financial markets as whole. In particular, firms will

benefit from the reduction of complaints, litigation costs, fines, etc and from a negative impact on reputation.

- reduction of risks linked to regulatory or supervisory arbitrage due to an increased degree of harmonisation and more consistent supervisory convergence;
- positive effects from improved harmonisation and standardisation of the processes that firms have to put in place when implementing the MiFID II product governance framework;
- positive effects from improved harmonisation and standardisation for competent authorities on the costs and activities needed to implement the new supervisory processes related to product governance; and
- reduced risk of greenwashing in the manufacturing and distribution of products.

## **Costs**

60. With reference to the costs, it should be firstly reminded that the key aspects of the product governance requirements and of these guidelines have remained unchanged. Moreover, the proposed amendments mostly concern clarifications rather than completely new approaches.

61. In light of what has been said, it can be reasonably expected that those firms having already in place a complete set of arrangements to comply with the existing MiFID II provisions will presumably incur less overall costs when implementing the updated framework and these guidelines.

62. ESMA considers that potential and incremental costs that firms will face when implementing the overall product governance framework under the MiFID II regime (including but not limited to these draft guidelines) might have both a one-off and an ongoing nature, arguably linked to:

- (direct) costs linked to the update/review of the existing procedural and organisational arrangements (e.g. the review and/or the update of firm's arrangements to identify the target market for products, due to the specification of any sustainability-related objectives);
- (direct) initial and ongoing IT costs; and
- (direct) relevant organisational and HR costs linked to the implementation of the guidelines.

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

## Conclusions

64. In light of what has been illustrated above, ESMA believes that the overall (compliance) costs associated with implementation of the updated regime on product governance (which includes the proposed guidelines) will be fully compensated by the benefits from the improved effectiveness of the firms' product governance arrangements.
65. ESMA also considers that the proposed guidelines are able to achieve an increased level of harmonisation in the interpretation and application of the product governance requirements across Member States, minimising the potential adverse impact on firms linked to compliance costs and will have a key role in the broader Commission's initiative on sustainable development. These benefits will outweigh all associated costs in respect of these guidelines.
66. Finally, ESMA believes that the adoption of guidelines is the best tool to achieve the explained objectives since this topic is already covered by existing guidelines. Furthermore, the adoption of guidelines further reduces the risk of diverging interpretations that might lead to discrepancies in the application and supervision of the relevant regulation and requirements across Member States (determining a risk of regulatory arbitrage and circumvention of rules).

### 3.3 Annex III – Draft Guidelines

#### I. Scope

##### Who?

1. These guidelines apply to:

- firms subject to any of the following requirements:
  - i. Article 9(3) of Directive 2014/65/EU<sup>16</sup> (MiFID II);
  - ii. Article 16(3) and 16(6) of MiFID II;
  - iii. Article 24(1) and 24(2) of MiFID II;
  - iv. Articles 9 and 10 of the Commission Delegated Directive (EU) 2017/593<sup>17</sup> (MiFID II Delegated Directive).
- competent authorities with supervisory oversight of the above firms.

##### What?

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

##### When?

3. These guidelines apply from [dd mm yyyy].

#### 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 IV and V include several good practices and a number of illustrative examples.

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<sup>16</sup> 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).

<sup>17</sup> 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).

These good practices and examples do not form part of 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' means investment firms (as defined in Article 4(1)(1) of MiFID II) and credit institutions (as defined in Article 4(1)(27) of MiFID II) when providing investment services and activities (as defined in 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 (as defined in Article 2(1)(b) of UCITS Directive<sup>18</sup>) and external Alternative Investment Fund Managers (AIFMs) (as defined in Article 5(1)(a) of the AIFMD<sup>19</sup>) 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 Directive and Article 6(4)(a) and (b) of the AIFMD);
- 'product' means (i) a financial instrument (within the meaning of Article 4(1)(15) of MiFID II), excluding bonds with no other embedded derivative than a make-whole clause and financial instruments that are marketed or distributed exclusively to eligible counterparties<sup>20</sup>, or (ii) 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 a 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 a 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.

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<sup>18</sup> 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).

<sup>19</sup> 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).

<sup>20</sup> In accordance with the exemption in Article 16a of MiFID II.

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 (6) and 24(2) of MIFID II**

### **3.3.1 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 product, the investment service and the target market of the product.
12. When a firm acts both as the manufacturer and distributor of products, the Guidelines set out below apply as relevant, and as long as the firm meets all the applicable manufacturer and distributor obligations.
13. In general, firms acting as manufacturers and/or distributors should substantiate and document choices made in the context of their product governance arrangements, including with regard to the target market identification and related distribution strategies.

### **3.3.2 Guidelines for manufacturers**

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

14. 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. In identifying the target market for a product, manufacturers should also take into account the results of the scenario and charging structure analyses undertaken for the relevant product.<sup>21</sup> 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, ratings of issuers, etc. or through

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<sup>21</sup> ESMA provided guidance on the application of the charging structure analysis requirement in Q&A 16.2-4 of its Questions and Answers on MiFID II and MiFIR investor protection and intermediaries topics ([https://www.esma.europa.eu/sites/default/files/library/esma35-43-349\\_mifid\\_ii\\_qas\\_on\\_investor\\_protection\\_topics.pdf](https://www.esma.europa.eu/sites/default/files/library/esma35-43-349_mifid_ii_qas_on_investor_protection_topics.pdf)).

“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.

15. Manufacturers should use the list of categories set out in these guidelines as a basis for identifying the target market for their products. The list of the categories is cumulative: 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 19-31 of the guidelines).
16. Manufacturers should detail/describe each of these categories, without merging categories, while taking into account their relationship and ensuring the consistency between different categories since they all contribute to the definition of the target market for a given product.
17. 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.
18. Manufacturers need to identify a potential target market<sup>22</sup>. 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.
19. 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”. To avoid possible misuse of the exemption provided in Article 16a MiFID II, 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.
  - 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

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<sup>22</sup> See Article 9(9) of the MiFID Delegated Directive.

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 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. If needed, firms should additionally take into account relevant risks that may not be measured by the risk indicator. For instance, it may be relevant to additionally assess the impact of currency risk on the target market for PRIIPs to be issued in a currency that is different from the reference currency of that target market.
  - e. Clients’ Objectives and Needs: The firm should specify the investment objectives and needs of target clients that a product is compatible with, including the wider financial goals of target clients or the overall strategy they follow when investing. 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”, “regular payments”, etc., as relevant. In addition, reference should be made to the expected investment horizon/recommended holding period (number of years the investment is to be held), duly considering the potential impacts for clients of an early exit (for example in terms of costs).
20. Within the broad category of clients’ objectives and needs, the firm should also specify any sustainability-related objectives the product is compatible with. To ensure a sufficient level of granularity of the target market, when identifying sustainability-related objectives, firms may specify, where relevant, the following aspects (in line with the definition of

“sustainability preferences” according to Article 2(7) of the MiFID II Delegated Regulation<sup>23</sup> and as further detailed in the ESMA Guidelines on certain aspects of the MiFID II suitability requirements):

- The minimum proportion of the product that is invested in environmentally sustainable investments as defined in Article 2, point (1), of Regulation (EU) 2020/852<sup>24</sup>;
- The minimum proportion of the product that is invested in sustainable investments as defined in Article 2, point (17), of Regulation (EU) 2019/2088<sup>25, 26</sup>;
- Whether, where relevant, the product has a focus on either environmental, social or governance criteria or a combination of them;
- Which principal adverse impacts (PAI) on sustainability factors are considered by the product, including quantitative or qualitative criteria demonstrating that consideration. Firms could use the categories presented in the SFDR RTS (instead of an approach based on each PAI indicator) such as “emissions”, “energy performance”, “water & waste”, etc.

21. 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.

22. 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**

23. The identification of the potential target market should be done for all products, in an appropriate and proportionate manner, considering the nature of the 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.

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<sup>23</sup> Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (OJ L 87, 31.3.2017, p. 1).

<sup>24</sup> Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 (OJ L 198, 22.6.2020, p. 13).

<sup>25</sup> Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (OJ L 317, 9.12.2019, p. 1).

<sup>26</sup> The product's minimum proportion referred in the two bullet points above is the one published in the product's binding contractual documentation such as the one referred to in Article 6 of Regulation (EU) 2019/2088 or any other relevant legal document.

24. In this context, manufacturers 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. Although complexity is a relative term, which depends on several factors, firms should also take into account, the criteria and principles identified in Article 25(4) of MiFID II.
25. 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 detail<sup>27</sup>.
- [...] Depending on the 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.
26. For certain particularly complex and risky products, such as contracts for difference (CFDs) and other products with similar characteristics, a very careful target market assessment is required resulting in the identification of a very narrow target market with the needs, characteristics and objectives of which such products are compatible, or no compatible target market at all. If a manufacturer considers that there is a target market whose needs, characteristics and objectives a CFD, or a product with similar characteristics, is compatible with, such a target market should in any case be confined to high-risk seeking clients who are able and prepared to lose money, on average, with their investment and who are seeking speculative investments with only a small chance of earning positive returns.
27. Manufacturers may also decide to define the target market by adopting a common approach for some products if they have sufficiently comparable product features ("clustering approach"). When adopting a clustering approach, manufacturers should use a sufficient level of granularity to ensure that only products with sufficiently comparable characteristics and risk features are grouped together (i.e. clusters should be homogeneous in itself and heterogeneous towards other clusters). In ensuring that homogenous clusters are identified, firms should pay particular attention to the level of complexity of products, meaning that the more complex the underlying products of a cluster become, the more granular the clustering should be. Generally speaking, for certain more complex products, such as certain OTC derivatives or structured products, it is expected that a clustering approach will not be appropriate and that firms should define the target market at the level of the individual product.
28. Manufacturers should consider multiple key factors when clustering products, such as: 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; observability of the underlying (e.g. the use of unfamiliar or opaque indices); guarantees of principal repayment or capital protection clauses; liquidity of the product (i.e. tradability on trading venues, bid-ask spread, selling restrictions, exit charges); and the currency denomination of the product).

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<sup>27</sup> See Recital 19 of the MiFID II Delegated Directive.

29. When using a clustering approach, the manufacturer should always check and document for each specific product whether it belongs to a certain cluster and thus whether the target market identified for this cluster can be assigned to this product. For this purpose, clear criteria should be specified under each cluster. In any case, when using a clustering approach, manufacturers should consider the outcomes of the charging structure and scenario analyses of each product.
30. In all cases, including when using a clustering approach, 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.
31. 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**

32. 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 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.
33. 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.

### **3.3.3 Guidelines for distributors**

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

34. The distributor's target market identification (i.e. the identification of 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 and/or before deciding whether the product should be included in the firm's offer). In particular, the identification of the target market of products intended for distribution should ensure that the decisions

undertaken to define the distributor's product assortment are based on the consideration of the characteristics and needs of the distributor's client base.

35. In particular, distributors should take responsibility to ensure, from the very beginning, the general consistency of the products and investment and/or ancillary services that are going to be offered, and to choose which products are to be offered under the different services, to ensure compatibility with the needs, characteristics, and objectives of target clients. The aspects related to this general consistency of products, services and distribution strategies with target clients should be addressed and formalised in the firm's policy as to the services, activities, products and operations offered or provided.<sup>28</sup>
36. 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.
37. 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).<sup>29</sup> 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.
38. Specifically, distributors should decide which products are going to be recommended (also through the provision of portfolio management) or offered or actively marketed to certain groups of clients (characterised by common features in terms of knowledge, experience, financial situation, etc.). Distributors should also decide which products will be made available to (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.

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<sup>28</sup> In line with Article 9(3)(b) of MiFID II.

<sup>29</sup> 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'.

39. At the same general decision-making stages, distributors should consider what distribution strategies should be used for the different client groups, including the way in which products will be marketed. In particular, where firms intend to use behavioural finance and digital engagement practices such as gamification techniques<sup>30</sup> for the distribution of certain products, distributors should carefully assess whether using such techniques would be in the best interests of the client group for which such strategies would be used. Distributors should therefore determine to which groups of clients such services will be made available, based on the characteristics of the clients or potential clients. However, certain gamification techniques will never be in the interest of the client, such as those used in trading apps designed to nudge the (potential) client towards harmful behaviour (e.g., maximise the number of trades). Additionally, such techniques can contribute to the distribution of products outside of their target market. When determining the target market for their services, distributors should also pay particular attention to situations in which a bundle of services will be provided to clients, such as both execution services and the ancillary service of granting loans allowing the client to carry out the transaction.
40. 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**

41. 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**

42. Distributors should use the same list of categories used by manufacturers (see paragraph 19) as a basis for defining the target market for their products, also avoiding merging two or more categories (see paragraph 16). 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 products and the type of investment

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<sup>30</sup> Gamification techniques add games or game-like competitive elements to non-game contexts such as financial services. Examples of game-like elements are earning of points or badges; keeping score or leader boards; showing performance graphs; by using meaningful stories or avatars to engage users; or introducing teammates to either induce conflict, cooperation, or competition. Gamification is a type of digital engagement practice that can be used; in turn, digital engagement practices refer to how actively users interact with a software application or platform.

services they provide and the level of detail of information gathered from clients. In this context, distributors should ensure that the concepts used for the definition of the actual target markets for products are aligned with the concepts used in the context of the suitability and appropriateness arrangements. For example, regarding the manufacturer's target market category of knowledge and experience, which may broadly refer to "basic", "average" or "advanced" investors, the distributor should adopt a more granular classification consistent with its suitability or appropriateness arrangements, where appropriate given the features of the products; another example would be a distributor that, in relation to the category clients' risk tolerance, specifies clients' willingness to take the risk of a decline in the product's value by a certain percentage. Importantly, when defining the actual target market for products, distributors should use consistent terms and definitions and should ensure consistency between the actual target markets defined for products with homogeneous product features.

43. 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.
44. 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.
45. 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.
46. 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 manufacturers 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. To ensure a proper scrutiny of such more complex products, distributors should also determine whether, next to the manufacturers' target market description, they need access to underlying assessments such as the outcomes of the manufacturer's scenario and charging structure analyses. 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.

47. Distributors may also decide to define the target market by adopting a clustering approach for some products, in line with the principles of ensuring a sufficient level of granularity as indicated in paragraphs 27-29. For example, in ensuring that only UCITS with sufficiently comparable characteristics are clustered for the purposes of the target market identification, differentiating factors would be the types of asset classes the UCITS invests in, its investment strategy, risks, charging structure (e.g. level and types of costs), any leverage used, and so on. Such factors should be used in a cumulative manner.
48. 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.
49. 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**

50. 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 product, in line with what described in paragraphs 23 to 31.
51. 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**

52. 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 50), but also on the type of investment services that firms provide.
53. 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.
54. 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 19(b)); where they only conduct execution services under the execution-only regime, not even the assessment of clients' knowledge and experience will usually be possible.<sup>31</sup> In this respect, firms should pay

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<sup>31</sup> As explained above (see paragraph 45), 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

particular attention to the distribution strategy suggested by the manufacturer (see paragraphs 33, 59 to 61).

55. 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).
56. 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 warning them that the firm is not in the position to assess their full compatibility with such products. In any case, as mentioned in paragraph 60, this decision should always be based on the consideration of the product's features (e.g. in terms of costs/complexity), 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 (i.e. ex ante) that the distribution strategy for the product (including its marketing and information strategy) will generally enable the product to reach the identified target market. Likewise, 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 (see also paragraph 72).
57. 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**

58. 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

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their disposal and gathered through other sources. Therefore, even firms only providing investment services under appropriateness or execution-only regime, could be in the position to conduct a more thorough assessment of the target market.

distribution strategy, the distributor should define its own distribution strategy in light of information on its client base and type of services provided.

59. Considering the nature of the product and the investment service, distributors should refine the distribution strategy as identified by the manufacturer taking into account the characteristics of the distributor's client base. In particular, in making such a refinement, where the distributor 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 (e.g., active marketing, the use of behavioural finance and/or gamification techniques, 'finfluencers'<sup>32</sup>, and so on). 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; and
- Whether and how the product should be displayed in the client's choice environment. For example, a distributor could decide not to show a more complex product on a prominent place on the website or at the top of a client's search results, or could decide to show such a product only if the client specifically requests it.

60. In particular, while taking into due consideration the suggested distribution strategy of the manufacturer, the distributor could decide to follow a more prudent approach by providing investment services that afford a higher level of protection to investors, such as investment advice. For instance, if the manufacturer considers that the features of a given product are compatible with a distribution strategy through non-advised services, the distributor may still decide that the characteristics of its 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.

61. 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

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<sup>32</sup> An influencer is usually someone who is active on social media and has:

- the power to affect the purchasing decisions of others because of his or her authority, knowledge, position, or relationship with his or her audience; and
- a following in a distinct niche, with whom he or she actively engages. The size of the following depends on the size of his/her topic of the niche.

In the case of a 'finfluencer' the influencer generates content on financial topics such as investments.

governance process and when selecting suitable distributors (as described in paragraphs 32 and 33).

### **Portfolio management, portfolio approach, hedging and diversification**

62. 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.
63. 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).
64. Providing investment advice adopting a portfolio approach or portfolio management services does not exempt the firm from defining a target market for each product to be distributed and from monitoring deviations from the target market to ensure that products are only distributed outside the target market when this can be justified for diversification or hedging purposes. Moreover, a deviation from the product's target market categories "client type" and "clients' knowledge and experience" cannot be justified for diversification or hedging purposes<sup>33</sup>.
65. 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.
66. 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 80-88).

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

67. 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, including any sustainability-related objectives, of the identified target market and whether the intended distribution strategy remains appropriate.

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<sup>33</sup> In the case of portfolio management, given the specific nature of the service, the level of "clients' knowledge and experience" of the target market can be in line with the approach suggested in ESMA Guidelines on suitability.

68. Firms should use both quantitative and qualitative criteria to review products, relating to the product's characteristics (e.g. changes in the product's risk factors, investment strategy, cost structure (e.g. level and types of costs), ...), market conditions (e.g. adverse market conditions, regulatory developments, ...) and distribution (e.g. 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 in such cases to a large extent be driven by client complaints and/or market events that significantly affect the product's risk-return profile.
69. 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 clients, 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.
70. 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. Whenever distributors have relevant information to support reviews by MiFID manufacturers, they should proactively provide it to the manufacturer and not provide such information only at the manufacturer's request. 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).
71. 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 65.
72. For the purposes of their own review, distributors should determine what information they need in order to be able to draw reliable conclusions on whether products have been distributed to the identified target market, and not (systematically) outside it. To be able to draw such reliable conclusions, firms may need to gather further information about their clients, for example by sending a questionnaire to a sample of their clients that have bought

a product under non-advised services. Furthermore, firms should reconsider their distribution strategy for more complex products distributed through non-advised sales, if, for example, the review shows that such products are too often distributed outside the positive target market (or even in the negative target market).

73. Distributors are required to review products as long as they are offered, sold or recommended. For example, where a distributor no longer offers<sup>34</sup>, 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 that product. Where a distributor recommends to its clients to hold a product it no longer offers or sell, it should still be required to review the target market of that product.

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

74. 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.

75. Where a product has not been designed in accordance with the MiFID II product governance requirements (for example, in the case of 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<sup>35</sup> (see paragraph 42). 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 23).
- 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 market<sup>36</sup>. Where all relevant information is not publicly available (for example, through the PRIIPs<sup>37</sup> 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 requirements<sup>38</sup>.

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<sup>34</sup> In this context, ‘offered’ has a wide application and should be read in a broad sense.

<sup>35</sup> See Article 10(1) of the MiFID II Delegated Directive.

<sup>36</sup> See subparagraph 3 of Article 10(2) of the MiFID II Delegated Directive.

<sup>37</sup> 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).

<sup>38</sup> See Article 10(2) of the MiFID II Delegated Directive.

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.

76. The obligation referred to in paragraph 75 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 product<sup>39</sup>. 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.
77. 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.**

[...]

78. Products which were manufactured before 3 January 2018 and continue to be distributed to investors should fall within the scope of product governance requirements applicable to distributors, in particular, the requirement to identify a target market for any 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.
79. However, a target market should be assigned by the manufacturer to such products, at the latest, following the next product review process cycle 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.

#### **3.3.4 Guidelines on issues applicable to both manufacturers and distributors**

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

80. The firm needs to consider whether the product would be incompatible with certain target clients (“negative” target market)<sup>40</sup>. When doing so, the firm should apply the same categories and principles as stated above in paragraphs 14-22 and 42-49. 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

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<sup>39</sup> See subparagraph 3 of Article 10(2) of the MiFID II Delegated Directive.

<sup>40</sup> See Articles 9(9) and 10(2) of the MiFID II Delegated Directive.

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.

81. 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 (groups of clients) with compatible sustainability preferences. The same products could still be distributed to clients falling outside that "positive" sustainability-related target market, provided that they are compatible with the features of the other target markets categories defined by these Guidelines<sup>41</sup>. 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 (client type, knowledge and experience, financial situation, risk tolerance and objectives and needs), but should not consider the sustainability-related objectives of the products. This is to assess whether these other target market aspects might be incompatible with certain target market clients, for example, if the product that considers sustainability factors concerns a risky product intended for clients with a long-term investment horizon and willing and able to lose their investment amount (in which case the product would not be compatible with clients that would have a low risk tolerance).
82. 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.
83. Again, it is important to take account of the principle of proportionality. When assessing a potential negative target market, the number and detail of factors and criteria will depend on the nature, especially the complexity or the risk-reward profile, of the product (i.e. a plain vanilla product is likely to have a smaller group of possible investors for whom it is incompatible, while the group of clients for whom the financial instrument is not compatible might be large for a more complex product).
84. 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

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<sup>41</sup> Recital 7 of Delegated Directive (EU) 2021/1269 explains that "To ensure that financial instruments with sustainability factors remain easily available also for clients that do not have sustainability preferences, investment firms should not be required to identify groups of clients with whose needs, characteristics and objectives the financial instrument with sustainability factors is not compatible".

facts of the case, the reason for the deviation should be clearly documented and, where provided, included in the suitability report.

85. 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.
86. 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 product that is in the 'grey' area, i.e. between the positive and negative target markets.
87. 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.
88. 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 65.

## **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*

89. The requirements set out in Article 16(3) and 24(2) of MiFID II apply to services and products manufactured and/distributed to retail and professional clients. At the same time, these articles 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 19(a). Moreover, pursuant to Article 16a of MiFID II, firms are exempt from the application of Articles 16(3) and 24(2) of MiFID II (as well as from Articles 9 and 10 of MiFID II Delegated Directive), where a product is marketed or distributed exclusively to eligible counterparties (as “end clients”).
90. 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”.
91. 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.
92. 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 as end-clients

93. 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). [...]

[...]

94. Firms are entitled to assume that professional clients have the required knowledge and experience to understand the risks attached to the particular products or services for which they have been classified as a professional client<sup>42</sup>. MiFID nonetheless, makes a distinction between per se professional clients and elective professional clients – providing that clients

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<sup>42</sup> See Annex II of MiFID II.

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

95. Therefore, firms should, when carrying out their target market identification, consider the differences in assumed knowledge between retail and professional clients and, within the professional client category, elective professional clients and per se professional clients<sup>43</sup>. For example, the contrast in approach should take account of the differences in the knowledge and experience profiles of these different client categories.

96. 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.

[...]

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<sup>43</sup> See subparagraph 2 of section II.1 of Annex II of MiFID II.

### 3.4 Annex IV – Good practices

Below is a list with examples of good practices based on NCAs' supervisory experiences with firms' compliance with the product governance requirements, also in the context of the 2021 CSA. ESMA expects that such examples will help firms comply with the relevant requirements. The 2021 CSA also revealed several areas for which there was room for improvement in the application of the product governance requirements by firms. However, ESMA has chosen to only include examples of good practices below because it believes that such examples will be most helpful for firms in complying with the product governance requirements.

| <b><i>Areas of product governance</i></b>                 | <b><i>Good practices</i></b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               |
|-----------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b><u>Distribution strategy by the manufacturer</u></b>   | Conducting due diligence on potential distributors through qualitative checks to verify the distributor's ability to comply with product governance rules. This due diligence is carried out before the distribution agreement is signed and is updated regularly. The due diligence involves a questionnaire aimed at collecting information on different aspects of the distributor's business model (including the type of target clients and distribution methods) as well as internal controls on product governance. |
|                                                           | In defining the distribution strategy for a more complex product, emphasizing to distributors the importance of applying (additional) measures as part of their distribution strategy to prevent sales outside the target market. Manufacturers could, for example, state the relevance for distributors to only apply online persuasive techniques in the best interest of the client when these products are distributed via non-advised services.                                                                       |
| <b><u>Target market assessment by the distributor</u></b> | Challenging the decisions made by the manufacturer in its target market assessment, resulting in the identification of a narrower target market by the distributor, for example because it identifies higher required level of clients' knowledge or experience or risk tolerance for a given product than identified by the manufacturer.                                                                                                                                                                                 |
|                                                           | When assessing the target market for a more complex product, directly engaging with the relevant manufacturer to better understand the rationale behind important decisions made in the manufacturer's target market assessment.                                                                                                                                                                                                                                                                                           |
|                                                           | Distributors setting clear and detailed rules in their distribution agreements with manufacturers about the                                                                                                                                                                                                                                                                                                                                                                                                                |

| Areas of product governance                                                          | Good practices                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |
|--------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                                                                      | <p>extent of information to be exchanged by them, the timing and the means to be used for this purpose.</p> <p>Distributors of investment funds requesting the same level of information from non-MiFID manufacturers as from MiFID-manufacturers to be able to properly identify the target market for such products.</p>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
| <p><b><u>Distribution strategy distributor</u></b></p>                               | <p>When assessing the compatible distribution strategy for a given product, restricting its distribution to advised sales only while the manufacturer also identified non-advised sales as compatible, for example because the product is considered too complex for non-advised sales or because the product is characterised by conflicts of interest. Such a decision is also reported to the manufacturer because it is relevant information for the manufacturer's periodic review of the product.</p> <p>Implementing blocking mechanisms in the distributor's systems to ensure that the product is distributed to the identified target market to effectively limit the possibility of sales outside the positive target market and/or into the negative target market (depending on the predefined distribution strategy). For example, blocks limiting sales to retail clients of products that have professional clients (and ECs) as a target market, or limiting sales to retail clients with basic knowledge and experience of products with a target market of advanced/very experienced clients.</p> |
| <p><b><u>Timing and relationship with other product governance processes</u></b></p> | <p>Comparing a possible new product with existing products in the distributor's offer, in terms of complexity, costs and risks, before deciding whether to include or replace it in the distributor's offer.</p> <p>When defining the actual target market of certain products, for example in relation to clients' risk tolerance or financial situation and ability to bear losses, the firm decides that, based on the portfolio approach adopted for suitability assessment, such products can be sold to clients that fall outside the positive target market only up to a certain pre-defined percentage of such clients' assets.</p>                                                                                                                                                                                                                                                                                                                                                                                                                                                                          |
|                                                                                      | <p>Refining the granularity of the product clustering based on the outcomes of a product review, for example by</p>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |

| <b>Areas of product governance</b>                                    | <b>Good practices</b>                                                                                                                                                                          |
|-----------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b><u>Product review (by the manufacturer or the distributor)</u></b> | developing more granular clustering of fixed-income instruments in terms of their credit rating.                                                                                               |
|                                                                       | Removing certain products from the product offer because the outcomes of the product review revealed that they do not longer offer value for money, for example due to falling interest rates. |

### 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 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-risk<sup>44</sup> 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:

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<sup>44</sup> In line with paragraph 22 of the guidelines, firms should clearly define concepts and terminology used

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).

#### 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]%<sup>45</sup> 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]<sup>46</sup> risk & reward profile and is therefore compatible with clients need to have a low to medium<sup>47</sup> 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 years<sup>48</sup>)
- 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

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<sup>45</sup> The firm should specify the percentage based on the characteristics of the product.

<sup>46</sup> The firm should use the risk indicator of the UCITS KIID.

<sup>47</sup> In line with paragraph 22 of the guidelines, firms should clearly define concepts and terminology used.

<sup>48</sup> The firm should quantify the investment horizon based on the specific duration of the product



## 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 6 – Target market assessment of listed options on large cap EU share

### *Premium*

The premium is what a buyer of an options pays, and the writer of an option receives. The level of the premium is dependent on the risk associated with the option, relating to the remaining duration, exercise price, price of the underlying and the volatility. Especially with regard to writing options, a high level of knowledge and experience of these premium components is required to understand to what risk the investor is exposed and if the premium is a good reward for this risk exposure.

Options can be used in different ways. An investor could buy and write options, or s(h)e could also set up more complex option strategies with the use of different options (like spreads) and/or shares. The risk-reward profile differs depending on how the investors uses options. Therefore, the compatible target market should also be different depending on the different ways in which these products can be used.

### *Buying options*

The risk to investors of buying options is losing the paid premium if the option redeems worthless. Therefore, a client who is buying call or put option should be prepared to lose 100% of the premium paid. Because of the complicated features of options, experience with investing is expected, as well as knowledge about the financial markets and 'mass retail' products.

### *Writing options*

In case of uncovered writing options, the client is exposed to the risk of high losses since the price of underlying can move against the expectation of the writer. Due to this risk, the client can lose more money than the initial received premium and in case of an uncovered written call option, an investor is exposed to potentially infinite losses. Also, clients can be confronted with margin calls, which the client needs to understand, as well as the financial ability to deposit those additional funds. With regard to experience, experience with buying options is required. Below, all components, rights and obligations have been plotted against the five target market categories.

It is also possible to write a call option while the investor owns the underlying, this is called covered writing. In this case, if the call option ends into-the-money, the investor has the underlying value to deliver to the buyer of the option. This means that the writer of the option does not face any losses due to the rising value of the underlying value. Therefore, the risk is much lower than for uncovered writing options.

### Multiple leg strategies

Investors can combine different options within one single order to set up option strategies such as butterfly and calendar spreads. In such strategies, the combination of options changes the risk-reward profile. Because of the complex nature of setting up option strategies and the possible financial consequences of making a mistake, option strategies should only be available to very experienced investors.

|                                | <u>Knowledge required</u> | <u>Experience required</u> | <u>Financial situation (&gt;100%, 100%, large part, part of premium to lose)</u> | <u>Risk tolerance</u> | <u>Objectives and needs (non exhaustive)</u>              |
|--------------------------------|---------------------------|----------------------------|----------------------------------------------------------------------------------|-----------------------|-----------------------------------------------------------|
| <u>Type</u>                    |                           |                            |                                                                                  |                       |                                                           |
| <u>Buying call</u>             | ✓                         |                            | <u>100% of premium</u>                                                           | <u>2</u>              | <u>Hedge, speculate</u>                                   |
| <u>Buying put</u>              | ✓                         |                            | <u>100% of premium</u>                                                           | <u>2</u>              | <u>Hedge, speculate</u>                                   |
| <u>Writing call (covered)*</u> | ✓                         | ✓                          | <u>Missing upside potential of exercise price</u>                                | <u>7*</u>             | <u>Hedge, speculate</u>                                   |
| <u>Writing put</u>             | ✓                         | ✓                          | <u>Actual value underlying - (exercise price + premium)</u>                      | <u>2</u>              | <u>Receive premium at stable prices, hedge</u>            |
| <u>Writing call uncovered</u>  | ✓                         | ✓                          | <u>∞</u>                                                                         | <u>2</u>              | <u>Receive premium at stable prices, hedge</u>            |
| <u>Option strategies*</u>      | ✓                         | ✓                          | <u>∞</u>                                                                         | <u>7*</u>             | <u>Receive premium at stable prices, speculate, hedge</u> |

*\* From a product specific perspective, the risk is high. If applied correctly, these ways of using an option can lower the risk of a portfolio. Therefore, if distributed via investment advice, the risk appetite of the target market can be lower since the portfolio approach is accepted within investment advice.*

### Distribution strategy

Given the high risk and highly complex features of options, the product is preferably only to be distributed via advised services. If options will be distributed via non-advised services, additional measures, such as relating to the marketing strategy and the online choice environment, should be taken to ensure these products will only end up with the right target market. Focusing on the online choice environment, the following have been made:

1. A distinction between two types of accounts: “basic” and “advanced” accounts. By means of a tool that distinguishes clients based on the five target market categories, clients are directed to either one of these accounts.
2. For the “basic” account only ‘mass retail’ products are made available, excluding products like options.
3. In the “advanced” account also other products are accessible for the client, including options. Additional measures are taken before clients can start trading options.
4. If a client wants to buy an option, two steps have to be taken:
  - a. A passed appropriateness test specifically for options is required, assessing a client’s detailed knowledge and experience with respect to the functioning of options.
  - b. A clear target market description of the specific option is shown taking into account the way it will be used by the client (for instance when the client wants to buy a call, the specific target market for buying a call option is shown) and the client actively has to accept or reject it. When the client rejects it, it is not possible to buy options.
5. If a client wants to write options or to set up option strategies:

- a. An additional appropriateness test is necessary, assessing the client's knowledge and experience with respect to the additional risks of writing options (such as margin calls).
- b. An agreement should be signed in which the client confirms that s(h)e understands the potential consequences of writing options or setting up option strategies, such as incurring high losses and meeting margin calls. In addition, the firm will contact the client to ask control questions to assess whether the client truly belongs to the target market.

### **3.6 Annex VI – ACP Advice on Proportionality of the ESMA Product Governance Guidelines**

The ESMA Advisory Committee on Proportionality (ACP) was set up to advise ESMA on aspects of proportionality under its remit.

The ACP has assessed the ESMA Product Governance Guidelines (the Guidelines) to see whether proportionality is adequately taken into account.

The Guidelines contribute to a core mission of ESMA: fostering investor protection across the Union. More specifically, they aim at facilitating the implementation of a fundamental change introduced to the European financial product distribution requirements set out in MiFID II. Manufacturers and distributors of financial products and services should ensure robust processes for the design of financial products and services, the identification of target investors (the “target market”) and the ongoing monitoring of distribution activities. Manufacturers should also oversee distributors and sub-distributors to ensure compliance with their distribution strategies. The Guidelines have been in use since January 2018 and include explicit references to proportionality and the ACP considered them to represent a relevant topic for its first proportionality check, both from a design and implementation perspective.

The ACP notes – following the use of a survey carried out with NCAs – that in a few areas there is room to enhance proportionality in the Guidelines and proposes that ESMA look into the following areas in the context of the review of the Guidelines which is due by end 2022.

Firstly, although some feedback received by the ACP indicated that target markets are not always adequately defined by market participants, there is no evidence of proportionality shortcomings in the Guidelines in this respect.

There seems to be, however, a recurring difficulty linked to observed approaches of clustering typically when instruments of too different profiles are put into the same cluster. The ACP would thus recommend that clustering is considered for further elaboration in the Guidelines, with a view to introduce more clarity on how to apply a proportionate approach to clustering, where possible.

Secondly, on the issue of Regular Review, while the Guidelines were well understood by most national competent authorities (NCAs) the ACP would see merit in addressing some requests made for clarity on how to apply proportionality in the context of the regular review. The Guidelines could for example clarify or illustrate the reporting duties of distributors in relation



to the financial instruments that are only available to clients under their own initiative execution only service and the time limit of the reviews in respect of financial instruments that were sold by the distributor in the past.

Thirdly, on the topic of Hedging, although the ACP appreciates the fact that the Guidelines are the result of a compromise, they would seem, on balance, to be sufficiently proportional. Nevertheless, the ACP encourages revisiting this point in the context of the review of the Guidelines as it seems that more elements in the field of hedging in portfolio management would benefit from clarification in a proportionate manner.

Fourthly, on the concept of the Negative Target Market, although some NCA's indicated that clarification on some areas, e.g. the "grey zone" would be appreciated, the ACP has not found any major evidence indicating significant difficulties in applying this part of the Guidelines.

Lastly, the ACP encourages ESMA to consider how best to provide more illustrative examples on areas highlighted above.