A&L Goodbody

FINANCIAL REGULATION

ESMA Guidelines on MiFID II product governance requirements now applicable

ESMA's new Guidelines on MiFID II product governance requirements came into effect on 3 October 2023.

The Guidelines aim to ensure that firms which manufacture and distribute financial instruments and structured deposits act in the best interests of clients during all stages of the life cycle of products and services.

10 MIN READ

Background

Directive 2014/65/EU (**MiFID II**) and Commission Delegated Directive (EU) 2017/593 (**MiFID II Delegated Directive**) introduced product governance requirements for firms that manufacture and distribute financial instruments and structured deposits (together referred to as **products** below).

In June 2017, ESMA published its original Guidelines on MiFID II product governance requirements. While the Guidelines remained relevant, several regulatory and supervisory developments prompted a review of the Guidelines. The regulatory developments included Directive (EU) 2021/338, which introduced changes to MiFID II following the Covid-19 pandemic, and sustainability-related amendments to the MiFID II Delegated Directive which were introduced on 2 August 2021 by Commission Delegated Regulation (EU) 2021/1269 on the integration of sustainability factors into product governance obligations for investment firms. These amendments to the MiFID II Delegated Directive have applied since 2 August 2022.

To assist with the review of the 2017 Guidelines, ESMA launched a consultation on changes to the Guidelines on 8 July 2022. Following the consultation, ESMA published its final report on new Guidelines on MiFID II product governance requirements on 27 March 2023.

The Guidelines

On 3 August 2023, ESMA formally published the Guidelines, which have applied since 3 October 2023. The Guidelines may be used by investment firms, credit institutions, and AIFMs and UCITS management companies with relevant MiFID II 'top up' permissions (together referred to in this note as **firms, manufacturers or distributors**, as appropriate) as a guide for ensuring compliance with the new sustainability-related requirements in the MiFID II Delegated Directive.

Some of the key points in the Guidelines are outlined in summary below, according to whom they apply to.

Manufacturers

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

The Guidelines provide that manufacturers should not solely use quantitative criteria but also use sufficient qualitative criteria when identifying potential target markets.

The Guidelines set out a list of categories that manufacturers should use as a basis for identifying the target market for a product. 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.

The list of categories includes:

- type of clients to whom the product is targeted (based on the MiFID II client categorisation)
- knowledge and experience of the target clients (e.g. regarding the product type and product features)
- financial situation with a focus on the ability to bear losses
- risk tolerance and compatibility of the risk/reward profile of the product with the target market
- clients' objectives and needs

Manufacturers should describe each of these categories, without merging categories, while taking into account their relationship and ensuring the consistency between different categories. The Guidelines also recommend against excluding any of the five categories. If the five categories are deemed 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.

Furthermore, within the broad category of clients' objectives and needs, firms should also specify any sustainability-related objectives that the product is compatible with. In this regard, to ensure a sufficient level of granularity of the target market, when identifying sustainability-related objectives, firms may specify the following aspects (where relevant):

- the minimum proportion of the product that is invested in environmentally sustainable investments as defined in Article 2(1) of Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment
- the minimum proportion of the product that is invested in sustainable investments as defined in Article 2(17) of Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector
- which principal adverse impacts on sustainability factors are considered by the product, including quantitative or qualitative criteria demonstrating that consideration
- whether the product has a focus on either environmental, social or governance criteria or a combination of them

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 these five categories.

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

The Guidelines recommend that identification of the potential target market for all products should be conducted in an appropriate and proportionate manner, considering the nature of the product. This means that manufacturers should consider the characteristics of the product, including its complexity (including costs and charges structure), risk-reward profile, liquidity or its innovative character.

In respect to the complexity of a product, it is recommended that manufacturers define and adequately graduate the level of complexity to be attributed to manufactured products to determine the necessary level of detail with which the target market should be identified. For more complex products, the target market should be identified with more detail. For simpler, more common products, the target market should be identified with less detail. As such, the description of one or more of the above-mentioned categories for identifying the target market may be more generic (the simpler a product is, the less detailed a category may be).

The Guidelines acknowledge that manufacturers may decide to define the target market by adopting a common approach for some products if they have sufficiently comparable product features (known as a 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. 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. For certain more complex 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. The Guidelines provide further detail on the key factors that should be considered, and the steps that should be taken, when using the clustering approach.

Distributors

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

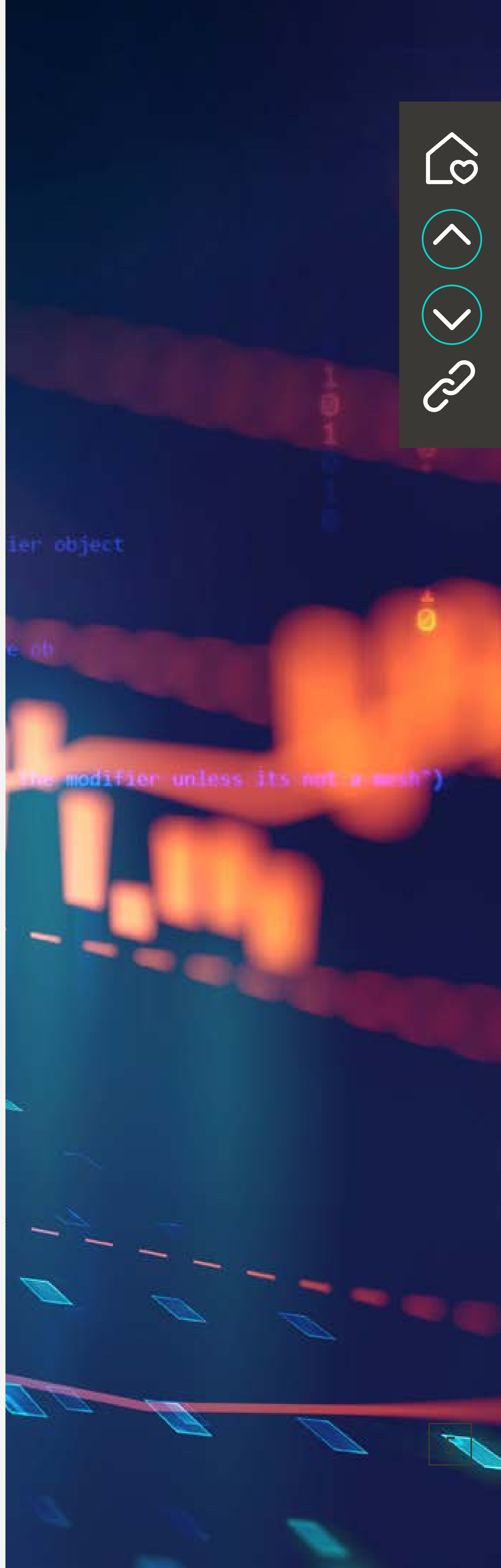
The Guidelines provide that the distributor's target market identification should be conducted as part of the general decision-making process about the range of services and products the distributor will distribute. This means the actual target market identification should occur at an early stage on an ex-ante basis (i.e. before deciding on whether the product should be included in the firm's offer) based on the firm's business policies and distribution strategies. During this early stage, distributors are expected to take responsibility for the general consistency of the products and investment services to be offered to ensure that they are compatible 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 regarding the services, products, activities and operations offered or provided.

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. In this context, the Guidelines provide that distributors should especially focus on the investment services through which the products will be offered to their respective target markets. For example, if a distributor has detailed information on certain clients (for example, through an existing relationship 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.

At the same general decision-making stages, distributors should also consider what distribution strategies should be used for different client groups (based on the characteristics of the clients), including the way in which products will be marketed. For example, where firms intend to use nudging and digital engagement practices such as gamification techniques 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. Indeed, certain gamification techniques will never be in the best interest of the client.

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

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 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 with another group of clients for whom the product may not be compatible.

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

Distributors should use the same categories as manufacturers for defining the target market for their products (see list of categories above). However, the Guidelines add that distributors should define the target market on a more 'concrete level' and should take into account the type, and characteristics, of clients, the nature and type of products and investment provided, information received from clients and from the manufacturer (if any) and information regarding the existing and prospective client base that has been obtained by the distributor via desk research or through the provision of investment or ancillary services.

The Guidelines acknowledge that distributors may decide to define the target market by adopting a clustering approach in line with the principles of ensuring a sufficient level of granularity as outlined for manufacturers.

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

The identification of the target market by the distributor should be conducted in an appropriate and proportionate manner, considering the nature of the product, as outlined for manufacturers.

Distribution strategy of the distributor

While a distributor should take the distribution strategy identified by a manufacturer into account and review it with a critical look, it should ultimately define its own distribution strategy in light of information on its client base (including the clients' characteristics) and type of services provided, thereby refining the distribution strategy identified by the manufacturer. When 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.

The Guidelines provide examples of decisions that distributors could take, in certain circumstances, in respect of their own distribution strategies while also taking into due consideration the suggested distribution strategy of the manufacturer:

- a distributor may 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 example, if a 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 (i.e. very limited knowledge / no experience with investments in that type of product or unstable financial situation) are such that investment advice would be the most appropriate choice to ensure their best interests
- a distributor may decide to take a less prudent approach in relation to the distribution strategy defined by the manufacturer (for example, if a manufacturer deems that a given product, due to its specific features, should be offered through investment advice, the distributor could nevertheless 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).

Guidelines applicable to both manufacturers and distributors

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

MiFID II and the MiFID II Delegated Directive require manufacturers and distributors to review products on a regular basis to assess whether the product remains consistent with the needs, characteristics and objectives of the identified target market, including any sustainability-related objectives, and whether the intended distribution strategy remains appropriate. The Guidelines specify, in detail, how such a review should be conducted.

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

The MiFID II Delegated Directive requires firms to consider whether a product would be incompatible with certain target clients (the 'negative' target market), taking into account the principle of proportionality. The Guidelines specify that when doing so, firms should apply the same categories and principles as mentioned for manufacturers and distributors for identifying a target market. Similar to the identification of a 'positive' target market, the manufacturer will identify the negative target market on a theoretical basis (i.e. with a more general view on how the specificities of a given product would not be compatible with certain investors), whereas the distributor, taking into account the manufacturer's more general negative target market as well as information on its own clients, will be in a position to identify more concretely the group of clients to whom it should not distribute that specific product.

For products which consider sustainability factors, the Guidelines provide that 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 products only contribute to identifying a 'positive' target market with compatible sustainability-related objectives. These products can still be distributed to clients who fall outside of the 'positive' sustainability-related target market objective, provided they are compatible with the features of the other target market categories defined by the Guidelines. As such, the Guidelines make clear that for products which consider sustainability factors, firms should always perform a negative target market assessment with respect to the five target market categories but should not consider the sustainability-related objectives of the products.

Next Steps

ESMA announced, on 3 October, that it will launch a Common Supervisory Action (CSA) with the national competent authorities on the integration of sustainability in firms' product governance processes and procedures and suitability assessment in 2024. The stated goal of the CSA is to assess the progress made by intermediaries in the application of the key sustainability requirements under MiFID II and the MiFID II Delegated Directive.

Conclusion

The product governance requirements have proven to be one key element of the MiFID II investor protection framework. By pursuing the objective of ensuring a consistent, uniform and harmonised application of the product governance requirements, the Guidelines will further strengthen investor protection within the EU.

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Resources

- Commission Delegated Directive (EU) 2017/593 — READ MORE
- Commission Delegated Regulation (EU) 2021/1269 — READ MORE
- ESMA Consultation Paper — READ MORE
- ESMA Final Report — READ MORE
- ESMA Guidelines — READ MORE
- MiFID II — READ MORE