Financial Risk&Regulation

ESMA published its final report on the Guidelines of MiFID II on product governance requirements

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On 27 March 2023, ESMA[1] issued its final report on its recommendations on MiFID II product governance guidelines[2] (hereinafter "Guidelines"). The Guidelines relies heavily on the previously issued and longtime used guidelines of 2018[3] on this topic but has been revised along with recent regulatory changes[4] and in the light of ESMA's Common Supervision Action on Product Governance 2021.

Annex V of the final report contains the revised Guidelines, which defines clearer, more detailed, and more specific expectations than before for the product governance practices of investment product manufacturers and investment service providers (distributors). Also Annex VI of the documentation identifies good and bad practices.

The aim of the Guidelines is in line with the objectives of MiFID II, which is to ensure, as part of the investor protection framework, that only financial (investment) products that are in the best interests of clients are developed and marketed in the capital markets. The expectation of proportionality in application remains a basic principle. This means for product producers must seek implementation (with appropriate complexity) based on the complexity of the product, the investment service, and the target market, in case of distributors on the nature of the product and knowledge of the client base.

Expectations for product manufacturers

The product manufacturers, because they only possess abstract knowledge of prospective customers, could define the target market (the final investors for whom the product is intended) of the product. Mainly due to the reason of knowledge of the product and the characteristics of the markets and experience with the product, taking into consideration both quantitative and qualitative aspects, but more universally. A **new requirement** states that they must also explicitly include the outcome of the MiFID[5] Regulation's scenario and fee structure analysis (under certain negative scenarios, the target market for the product may be narrowed in terms of risk or loss bearing).

It is essential that the target market is always defined for the customer at the very end of the supply chain in case the product manufacturer supplies the product for distribution or resale to an organization that is an eligible partner, professional customer. Organizations like this do not need to be

1 European Securities and Markets Authority

2 27 March 2023, ESMA35-43-3448 Final report on the Guidelines on MiFID II product governance requirements

3 05/02/2018, ESMA35-43-620 Guidelines on MiFID II product governance requirements

4 European Commission's Capital Markets Recovery Package és a MiIFD II sustainability modification

5 Commission Delegated Directive (EU) 2017/593 Article 9 (10) and (12) assessed for the target market. These distributors are qualified as manufacturers and as such are obliged to determine the target market for the final customer according to the rules applicable to them.

The target market definition should be carried out for each financial product produced individually, with a level of detail appropriate and proportionate to the nature of the product, considering product characteristics, including its complexity (and cost structure), risk-return profile, liquidity, and innovative nature. The more complex the product, the more in-depth the analysis and the more detailed the definition of the target market. A **new requirement** here is that product manufacturers must define the level of complexity of the product and consider the level of complexity. In the case of high-risk or complex products (CDFs), the definition of the target market should be done very carefully, with a significant narrowing of the target market or even without defining a target market.

It is relatively **new** that it has been allowed for the product manufacturer to define the target market in sufficiently detailed, applicable homogeneous, and clearly defined product groups, so-called clusters, provided that the products included are not too complex. This means that the target market for sufficiently comparable products is defined according to similar principles. In such a case, the price structure and scenario analysis should also be considered.

The target market will continue to be assessed in accordance with the five mandatory criteria, which may be supplemented by other criteria chosen individually, depending on what the company can assess in sufficient detail based on the information shared with distributors. These criteria are type of customer; knowledge and experience; loss-bearing capacity; risk-bearing capacity; customer's purpose and need. **As a new aspect, the Guidelines** specifies that the client's purpose and need should also include aspects relating to the sustainability of the product (the minimum proportion invested in environmentally sustainable or sustainable investments and, where relevant, if the product also meets environmental, social and/or corporate governance criteria, which principal adverse impacts (PAI) have been considered).

The Guidelines states that each of the above categories should be examined separately. Categories should not be combined and that the depth of analysis should be determined individually depending on the type, nature, and characteristics of the product.

Finally, the manufacturer must also ensure that the targeted marketing strategy is in line with the identified target market. To do so, it must determine the exact channel through which it proposes to market the product, with or without advice, and take all reasonable steps to ensure that the actual marketing is carried out accordingly.

The tasks of distributors

Distributors must consider the restrictions, set by product manufacturers when defining the target market, which distributors, unlike product manufacturers, decide due to the information available to them about their customers, rather than basing it on their knowledge of product characteristics and markets.

The decision on the target market must be taken in advance, as part of the general product decision-making process, in a regulated way before the sale starts.

It is the distributor's responsibility to be consistent about what (type of) products are offered in which services (with or without advice and through which channels, and whether the product is actively offered or not). It is evident (and not new) that the distributor is responsible for ensuring that the product meets the needs, character, and objectives of the customer.

The distributor must also define the target market even if it is a new institution (and thus has no knowledge of the customers) or using its own data collection and research if the product manufacturer has not provided it or has not provided it in sufficient detail.

In defining the target market, the distributor is expected to consider particularly the nature of the product, precisely its complexity, risk elements, illiquidity, or innovation. In doing so, the distributor may decide at its own responsibility to define the target market more narrowly or more broadly. It may exclude so called "execution only" sales to a group of customers for certain products of high complexity or make such sales subject to a compliance and suitability test for certain less complex products. **A new element to be considered** in the design of the distribution strategy is the use of different sales techniques (for instance gamification or nudging, bundling of services, use of influencers), of which nudging is generally not considered an acceptable sales strategy.

The distributor assesses the target market along the same five categories (these categories cannot be combined) as the manufacturer, but **also a new requirement is set** to take sustainability into consideration and the **distributor** must be more specific in terms of the customer base, the level of information available, the nature of the product and the investment services provided, then the manufacturer. It should also ensure that the defined target market is consistent with the system and concepts used in compliance and suitability tests. **A new component** for distributors is also the need to assess whether it is necessary to provide access to the scenario analysis and fee structure analysis of the product manufacturer. The Guidelines confirms that the definition of a target market by the distributor and the corresponding sale is not a substitute for pre-sale compliance and suitability tests.

Distributors are also covered by **the new expectation** that they may use product clusters in their target market definition where justified. At the time of consideration of the category of knowledge and experience of customers, they may only assume the existence of such knowledge and experience for 'per se' professional customers, and for selected professional customers, the existence of such knowledge and experience must be assessed on an individual basis.

In target market definition, the type of services provided will influence the decision on the target market, because different levels of details are available about clients for different services (for instance more detailed information for portfolio management, minimal information for execution only), however the target market will influence the services provided (for instance the designation of investment advice as a sales strategy will provide greater investor protection).

For each product, the distributor should consider whether to offer the product to the customer as part of an advisory service or not. Where it wishes to actively recommend the product, it should carry out a more in-depth analysis in the context of advice. However, they should pay extra attention to cases where they are not able to carry out a deeper analysis and assessment e.g., in the case of complex products and execution only regimes, or conflicts of interest for which **new conditions are imposed by the Guidelines**. In such cases, the distributor should consider all information received from the product manufacturer about the target market and distribution strategy and, where suitable, refrain from selling either on an advised or non-advised basis, warning the client that it does not have sufficient information to assess target market fit.

The distributor should be critical of the manufacturing strategy generally defined by the product distributor, always fine-tuning it to his own customer base and regard his own marketing strategy. If, after a well-founded and thorough analysis, the distributor may deviate from the product manufacturer's definition of the distribution strategy, either in a restrictive or less restrictive direction.

A new ascertainment in the Guidelines is that in the portfolio approach (as well as during portfolio management), the sale of financial instruments outside the positive target market for diversification and hedging purposes is allowed if the portfolio is, after the product sale, overall suitable for the client's target market (and can be sold under the suitability and compliance test). However, in such a case, the consideration of the client type, knowledge and experience of the client cannot be waived and must still mind the product sale.

Sales outside the target market used in such a diversification or hedging manner do not need to be reported individually to the product manufacturer, if they fall outside the positive target market, but if they fall into the negative target market, they must be reported to both the product manufacturer and the customer. However, such cases outside the target market should always be specific (and as rare as possible), justified by the situation and well documented.

Obligations for both parties

The product manufacturer is more general and the distributor more specific in its customer base, using the same methodology and criteria as for the definition of a positive target market, to identify customer groups for which the product is not suitable (negative target market). Organizations are expected to assess in advance the situations where such sales may arise in their operations and how they intend to handle them, e.g., through internal policies that are mandatory for advisors.

A new provision is that for products that have sustainability criteria, it is not necessary to identify non-sustainable customers as a negative target market, for instance products that are sustainable or promote sustainability can be sold to such customers (if they meet the other criteria of the target market and the compliance and eligibility rules). If the product is sold to customers belonging to a specifically negative target market, this must also be exceptional, justified and documented.

Reviews

The Guidelines also contains **some clarifications and new expectations** on the review requirements. Regular reviews should be carried out for product characteristics, market conditions and distribution. Both the distributor and the product producer should continue to regularly monitor (from reports, customer complaints) sales to the target market, with quantitative and qualitative parameters to be used and frequency and detail to be pre-defined in a proportionate manner, at least according to the needs of the product producer (not necessarily reporting by transaction and instrument to the product producer, aggregated reporting is sufficient). At the same time, distributors are expected to be proactive, not only to provide data on request or at regular intervals, but also, where appropriate, to provide information to the product manufacturer when important data emerge outside the review cycle (e.g. when customer complaints identify sales outside the target market as a common phenomenon; or when the distributor discovers that a particular product no longer meets the originally defined target market at all). The review obligation continues till the product stays in circulation.

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The Guidelines will be translated into all national official EU languages and published on the official website of ESMA. The Hungarian National Bank will then have to provide ESMA with feedback on its intention to comply within 2 months. Although the Guidelines introduces new expectations at a few points, it is nevertheless an important supporting material for Hungarian investment product manufacturers and distributors in matters of interpretation of the unchanged rules.

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