

Chapter 2

FINANCIAL PRODUCT GOVERNANCE

Introduction

Clients, in particular retail clients, may face difficulties in understanding the risks and returns of certain types of products. Consumers of financial services may in fact be exposed to unexpected losses unless they are in a position to clearly understand the risk and reward profile of such products by means of a proper assessment of such products against their risk appetite. This may give rise to complaints, reputational risks for product manufacturers and distributors and ultimately to loss of confidence in the regulatory framework, and more broadly, in financial markets. Accordingly, sound product governance arrangements by Regulated Persons manufacturing and/or distributing products are fundamental for consumer protection purposes. Furthermore, such arrangements can reduce the need for product intervention actions by the MFSA and where applicable, the European Supervisory Authorities.

This Chapter is therefore aimed at setting out regulatory requirements applicable to Regulated Persons which manufacture and/or distribute products. In particular, these Rules establish, *inter alia*, the requirements relating to product design, identification of the target market for such products as well as product oversight, namely the policies which Regulated Persons should have in place to ensure that their products continue to be suitable for the target market identified by them. The applicability of these Rules depends on whether a Regulated Person is involved in the manufacturing or distribution of a specific product, or both. Moreover, this Chapter also deals with the information which Product Manufacturers should provide to Product Distributors so that the latter would be in a better position to effectively explain the characteristics of the products concerned, when distributing such products to clients. Furthermore, apart from being required to adhere to Rules applicable to both Product Manufacturers and Product Distributors, Regulated Persons solely concerned with product distribution are also subject to specific Rules, taking into account various factors such as the type of product being distributed and the origin of the Manufacturer on behalf of whom such products are being distributed.

Application

- R.2.1 The Rules and any relative guidance set out under the heading “*General Rules*” in Part A shall apply to all Regulated Persons when acting as Manufacturers and/or Distributors, unless otherwise indicated.
- R.2.2 In addition to the requirements of Part A, the Rules and any relative guidance set out in Part B shall apply to Regulated Persons which fall under point (i) and (ii) of the definition of Regulated Person in the Glossary to these Rules when acting as Manufacturers and/or Distributors.
- R.2.3 In addition to the requirements of Parts A and B, Manufacturers and/or Distributors of Structured Products are also required to comply with the Rules set out in the Part C Section 2.5 entitled “Rules applicable to Manufacturers and Distributors of Structured Products whose target market are Retail Clients.”
- R.2.4 In addition to the requirements of Part A, the Rules and any relative guidance set out in Part D shall apply to Regulated Persons which fall under point (iii) and (iv) of the definition of Regulated Person in the Glossary to these Rules when acting as Manufacturers and/or Distributors.
- R. 2.5 The Rules and the relative guidance set out in this Chapter shall not apply to:
- Regulated Persons falling under point (iii) and (iv) of the definition of ‘Regulated Person’ in the Glossary where such Regulated Person carries on the activity of reinsurance or captive re/insurance Services or Products that are explicitly exempted from the scope of the IDD, such as certain activities on an ancillary basis as defined in Article 1(3) of the said Directive;
- Products which consist of the insurance of “*large risks*” are defined in Article 13(27) of Directive 2009/138/EC (Solvency II).

Part A: General Rules applying to all Regulated Persons when acting as Manufacturers and/or Distributors unless otherwise indicated

- R.2.6 Manufacturers shall ensure that:
- a) They design Products to meet the needs of an Identified target market of end Clients within the relevant category of Clients,
 - b) The strategy of distribution of the Products is compatible with the Identified target market, and
 - c) They take reasonable steps to ensure that the Product is distributed to the Identified target market.

- R.2.7 A Manufacturer shall make available to any Distributor all appropriate information on the Product and the product approval process, including the Identified target market of the Product.
- R.2.8 Manufacturers and Distributors shall ensure that they always act honestly, fairly and professionally in accordance with the best interests of their Client when designing, valuing and pricing a Product as well as offering a Product.
- R.2.9 Manufacturers shall maintain, operate and review a product approval process for each newly developed Product and for significant adaptations of an existing Product before it is marketed or distributed to Clients.

The product approval process shall contain measures and procedures for designing, monitoring, reviewing and distributing Product, as well as for corrective action for Products that are detrimental to Clients.

The product approval process shall specify an Identified target market of Clients within the relevant category of Clients for each Product and shall ensure that all relevant risks to such Identified target market are assessed and that the intended distribution strategy is consistent with the Identified target market, and take reasonable steps to ensure that the Product is distributed to the Identified target market.

- R.2.10 A Manufacturer should set out the Product Governance and Oversight Arrangements in a written document, the product governance and oversight policy and make it available to its relevant staff.
- R.2.11 A Manufacturer shall ensure that the compliance function monitors the development and periodic review of Product Oversight and Governance Arrangements in order to detect any risk of failure by the Manufacturer to comply with the obligations set out in these Rules.
- R.2.12 A Manufacturer shall ensure that the compliance function involved in the product design process and is entitled to intervene and make appropriate changes at every stage.
- R.2.13 Where Manufacturers collaborate to manufacture a Product, only one target market needs to be identified.
- R.2.14 A Manufacturer shall ensure that staff involved in designing and manufacturing Products has the necessary skills, knowledge and expertise to properly understand the Products sold and the interests, objectives and characteristics of the Clients belonging to the target market.

- G.2.1 *This does not necessarily mean that new or fully separate arrangements are drafted; it can be sufficient to refer to existing documents where these contain the relevant information and just record additional information if and insofar as this is necessary. The Manufacturer may combine written arrangements as it sees fit in line with its organisational structure and processes.*
- G.2.2 *A proper implementation of Product Governance and Oversight Arrangements ensures that all relevant staff members have knowledge of and observe these arrangements for their respective area of activities. It also ensures that any changes to the arrangements are promptly communicated to them.*
- R.2.15 A Distributor shall understand and regularly review the Products it offers or markets, taking into account any event that could materially affect the potential risk to the Identified target market, as a minimum, to assess whether the Product remains consistent with the needs of the Identified target market and whether the intended distribution strategy remains appropriate, or whether the Product is reaching Clients for whose needs, characteristics and objectives it is not compatible.
- R.2.16 Where a Distributor advises on, or proposes, Products which it does not manufacture, it shall have in place adequate arrangements to obtain the information referred to in R.2.7 and to understand the characteristics and Identified target market of each Product.
- R.2.17 Distributors shall maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interests from adversely affecting the interests of its Clients. These arrangements must be proportionate to the activities performed, the Product sold and the type of the Distributor.
- G.2.3 *Manufacturers and Distributors shall ensure that Product Governance and Oversight Arrangements do not rely excessively on the judgement and discretion of a limited number of persons but incorporates the effective input of all relevant staff and senior management.*

Obligations for Distributors distributing products by Third Country Manufacturers

- R. 2.18 When Products are manufactured or issued by third-country manufacturer based in a non-EEA Member State, the Distributor shall take all reasonable steps to ensure that the level of product information obtained from the third country 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. Where all relevant and material information is not publicly or otherwise available, the reasonable steps required shall include an agreement with the manufacturer or its agent that the manufacturer or its agent will provide all relevant information.

Publicly available information may only be accepted if it is clear, reliable and produced to meet the requirements of any relevant EU Directive.

Part B: Rules applying to Regulated Persons falling under points (i) and (ii) of the Definition of ‘Regulated Person’ in the Glossary when acting as Manufacturers and/or Distributors

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

R.2.19 To identify the target market for its Products, a Manufacturer should take into consideration the following five categories:

- (a) The type of Clients to whom the Product is targeted: the Manufacturer should specify to which type of Client the Product is targeted. This specification should be made according to MIFID II client categorisation of “retail client”, “Professional Client” and/or “Eligible counterparty”.
- (b) Knowledge and experience: the Manufacturer 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.
- (c) Financial situation with a focus on the ability to bear losses: the Manufacturer 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 Manufacturer should specify the general attitude that target Clients should have in relation to the risks of investment. Since different Regulated Persons may have different approaches to defining risk, the Manufacturer should be explicit about the criteria that must be met in order to categorise a Client in this way. Manufacturers should use the risk indicator stipulated by the PRIIPS Regulation or the UCITS Directive, where applicable, to fulfil this requirement.
- (e) Clients’ objectives and needs: the Manufacturer should specify the investment objectives and needs of target Clients that a Product is designed to meet, including the wider financial goals of target Clients or the overall strategy they follow when investing.

R.2.20 A Manufacturer should use the list of categories set out in Rule 2.19 as a basis for identifying the target market for their Products. The list of the categories is cumulative. The Manufacturer shall analyse the relevance of each category for a

certain Product and align the depth of the identification in proportion to the type, nature and other features of the Product.

- R.2.21 When detailing/ describing each one of these categories, the Manufacturer shall take into account the relationship between different categories since they all contribute to the definition of the target market for a given Product.
- R.2.22 The Manufacturer shall not exclude any of the five mentioned categories. If, in the Manufacturer's view, these five categories are too restrictive to identify a meaningful target market, additional categories may be added. When deciding whether to use such additional categories or not, the Manufacturer may take into account the characteristics of the information-channels with distributors.
- R.2.23 A Manufacturer shall identify a potential target market. Since the Manufacturer does not have direct Client contact, the target market identification may be based on its theoretical knowledge and experience of the Product.
- R.2.24 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.
- R.2.25 In order to avoid the risk of misinterpretations and misunderstandings, the Manufacturer should clearly define the concepts and terminology used when defining the target market across the five categories listed above.
- G.2.4. *In order to strengthen investor protection, Manufacturers may refer to illustrative examples provided in Annex V of ESMA Guidelines on MiFID II product governance requirements (accessible through the following link: https://www.esma.europa.eu/sites/default/files/library/esma35-43-620_report_on_guidelines_on_product_governance.pdf). These examples aim to assist Regulated Persons to understand how the requirements of the Guidelines should apply.*

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

- R.2.26 The identification of the potential target market, should be done in an appropriate and proportionate manner, considering the nature of the Product. 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.
- R.2.27 Consequently, for more complicated Products, such as structured products with complicated return profiles, the target market should be identified with more detail.

For simpler, more common Products it is likely that the target market will be identified with less detail:

[i] For some types of Products the Manufacturer may identify the above-mentioned target market categories referred to in R.2.19 following a common approach for Financial Instruments of one type with sufficiently comparable Product features (for example due to an external benchmark, or because they belong to a stock-exchange segment with certain requirements).

[ii] 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.

R.2.28 In all cases, the target market must be identified at a sufficiently granular level to avoid the inclusion of any groups of Clients for whose needs, characteristics and objectives the Product is not compatible.

G.2.5 *The level of granularity of the target market and the criteria used to define the target market and determine the appropriate distribution strategy should be relevant for the Product and should make it possible to assess which Clients fall within the target market. For example to assist the ongoing reviews after the Financial Instrument is launched. For simpler, more common products, the target market could be identified with less detail while for more complicated products such as bail-inable instruments or less common products, the target market should be identified with more detail.*

R.2.29 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

R.2.30 The Manufacturer shall ensure that its intended distribution strategy is consistent with the Identified target market and 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.

R.2.31 In defining a distribution strategy for Products, the Manufacturer should determine the extent of the Clients' information necessary to the Distributor to properly assess the target market for its Product. Hence, the Manufacturer should propose the type of

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 Regulated Person could also specify the preferred acquisition channel.

- R.2.32 In the case of Financial Instruments the appropriate measures and procedures referred to in R.2.7 above, shall be without prejudice to all requirements under these Rules and Regulation No 600/2014 (MIFIR), including those relating to disclosure, suitability or appropriateness, identification and management of conflicts of interests and inducements.
- R.2.33 A Manufacturer shall also comply with the Rules in this Part when manufacturing Financial Instruments which encompasses the creation, development, issuance and/or design of Financial Instruments.
- R.2.34 Manufacturers shall establish, implement and maintain procedures and measures to ensure the manufacturing of Financial Instruments complies with the requirements on proper management of conflicts of interest, including remuneration. The Manufacturer shall ensure that the design of the Financial Instrument, including its features, does not adversely affect end Clients or does not lead to problems with market integrity by enabling the Manufacturer to mitigate and/or dispose of its own risks or exposure to the underlying assets of the Financial Instrument, where the Manufacturer already holds the underlying assets on own account.
- R.2.35 Manufacturers shall analyse potential conflicts of interests each time a Financial Instrument is manufactured. In particular, Manufacturers shall assess whether the Financial Instrument creates a situation where end Clients may be adversely affected if they take:
- (a) An exposure opposite to the one previously held by the Manufacturer itself;
or
 - (b) An exposure opposite to the one that the Manufacturer wants to hold after the sale of the Financial Instrument.
- R.2.36 Manufacturers shall consider whether the Financial Instrument may represent a threat to the orderly functioning or to the stability of financial markets before deciding to proceed with the launch of the Financial Instrument.
- R.2.37 Manufacturers shall , where they collaborate, including with entities which are not authorised and supervised in accordance with MIFID or third-country firms, create, develop, issue and/or design a Financial Instrument, to outline their mutual responsibilities in a written agreement.

- R.2.38 A Manufacturer shall periodically gather appropriate information as to the performance of the Product so as to improve the design and manufacture of other Products in development.
- R.2.39 Manufacturers of Financial Instruments that are distributed through other Manufacturers shall determine the needs and characteristics of Clients for whom the Financial Instrument is compatible based on their theoretical knowledge of and past experience with the Financial Instrument or similar Financial Instruments, the financial markets and the needs, characteristics and objectives of potential end Clients.
- R.2.40 Manufacturers shall undertake a scenario analysis of their Financial Instruments which shall assess the risks of poor outcomes for end Clients posed by the Financial Instrument and in which circumstances these outcomes may occur. Manufacturers shall assess the Financial Instrument under negative conditions covering what would happen if, for example:
- (a) The market environment deteriorated;
 - (b) The Manufacturer or a third party involved in manufacturing and/ or functioning of the Financial Instrument experiences financial difficulties or other counterparty risk materialises;
 - (c) The Financial Instrument fails to become commercially viable; or
 - (d) Demand for the Financial Instrument is much higher than anticipated, putting a strain on the Regulated Person's resources and/or on the market of the underlying instrument.
- R.2.41 Manufacturers shall determine whether a Financial Instrument meets the identified needs, characteristics and objectives of the target market, including by examining the following elements:
- (a) The Financial Instrument's risk/reward profile is consistent with the target market; and
 - (b) Financial Instrument design is driven by features that benefit the Client and not by a business model that relies on poor Client outcomes to be profitable.
- R.2.42 Manufacturers shall consider the charging structure proposed for the Financial Instrument, including by examining the following:
- (a) Financial Instrument's costs and charges are compatible with the needs, objectives and characteristics of the target market;

(b) Charges do not undermine the Financial Instrument's return expectations, such as where the costs or charges equal, exceed or remove almost all the expected tax advantages linked to a Financial Instrument; and

(c) The charging structure of the Financial Instrument is appropriately transparent for the target market, such as that it does not disguise charges or is too complex to understand.

R.2.43 Manufacturers shall ensure that the provision of information about a Financial Instrument to Distributors includes information about the appropriate channels for distribution of the Financial Instrument, the product approval process and the target market assessment and is of an adequate standard to enable Distributors to understand and recommend or sell the Financial Instrument properly.

R.2.44 Manufacturers shall review Financial Instruments prior to any further issue or re-launch, if they are aware of any event that could materially affect the potential risk to investors and at regular intervals to assess whether the Financial Instruments function as intended. Manufacturers shall determine how regularly they review their Financial Instruments based on relevant factors, including factors linked to the complexity or the innovative nature of the investment strategies pursued. Manufacturers shall also identify crucial events that would affect the potential risk or return expectations of the Financial Instrument, such as:

(a) The crossing of a threshold that will affect the return profile of the Financial Instrument; or

(b) The solvency of certain issuers whose securities or guarantees may impact the performance of the Financial Instrument.

Manufacturers shall, when such events occur, take appropriate action which may consist of:

(a) The provision of any relevant information on the event and its consequences on the Financial Instrument to the Clients or the Distributors of the Financial Instrument if the Manufacturer does not offer or sell the Financial Instrument directly to the Clients;

(b) Changing the product approval process;

(c) Stopping further issuance of the Financial Instrument;

(d) Changing the Financial Instrument to avoid unfair contract terms;

(e) Considering whether the sales channels through which the Financial Instruments are sold are appropriate where Regulated Persons become aware that the Financial Instrument is not being sold as envisaged;

(f) Contacting the Distributor to discuss a modification of the distribution process;

(g) Terminating the relationship with the Distributor; or

(h) Informing the MFSA.

R.2.45 Distributors shall, when deciding the range of Financial Instruments issued by themselves or otherwise and Services they intend to offer or recommend to Clients, to comply, in a way that is appropriate and proportionate, with the relevant Rules provided in this Chapter, taking into account the nature of the Financial Instrument, the investment service and the target market for the Product.

Distributors shall also comply with the requirements of these Rules when offering or recommending Financial Instruments manufactured by entities that are not subject to these Rules. As part of this process, such Distributors shall have effective arrangements to ensure that they obtain sufficient information about these Financial Instruments from these Manufacturers.

Distributors shall determine the target market for the respective Financial Instrument, even if the target market was not defined by the Manufacturer.

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

R.2.46 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 is going to distribute. Hence, the actual target market identification should occur at an early stage, when the Distributor'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).

R.2.47 The Distributor shall take responsibility to ensure, from the very beginning, the general consistency of the Products that are going to be offered and the related Services that will be provided with the needs, characteristics and objectives of target Clients.

R.2.48 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 Distributor's daily business is conducted, as the Management body's choices are implemented along the Distributor's 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.

- R.2.49 The Distributor shall focus on the Services through which the Products will be offered to their respective target markets. It should take into consideration the nature of the Products, paying attention to those Products characterised by complexity/risk features or by other relevant features (such as, for example, illiquidity and innovation).
- R.2.50 The Distributor shall 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).The Distributor 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.
- R.2.51 In any case, where on the basis of all information and data that may be at the Distributor's disposal and gathered through investment or ancillary services or through other sources, including the information obtained from the Manufacturer, 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 Services).

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

- R.2.52 The Distributor shall identify the actual target market and ensure that a Product is distributed in accordance with the actual target market, such Product 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 Clients 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

- R.2.53 The Distributor shall use the same list of categories used by the Manufacturer provided in R.2.7 as a basis for defining the target market for their Products. Moreover, the Distributor shall define the target market on a more concrete level and should take into account the type of Clients they provide investment services to, the nature of the investment products and the type of the investment services they provide.
- R.2.54 Since the Manufacturer has to specify the potential target market based on its theoretical knowledge and experience with a similar Product, it shall determine the Product's target market without specific knowledge of individual Clients. 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. The Distributor shall 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). The Distributor shall 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.

- R.2.55 The Distributor shall conduct a thorough analysis of the characteristics of their existing Clients, as well as prospective Clients. The Distributor shall use any information and data deemed reasonably useful and available for this purpose that may be at the Distributor's disposal and gathered through investment or ancillary services. In addition, it could use any information and data deemed reasonably useful and available that may be at the Distributor's disposal and gathered through sources other than the provision of investment or ancillary services.
- R.2.56 The Distributor shall not deviate from the fundamental decisions made therein. The Distributor cannot 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, the Distributor 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. 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.
- R.2.57 The Distributor shall make a target market assessment after the Manufacturer has communicated its target market to him. 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. Both the Manufacturer and the Distributor retain their responsibility for their obligations to identify a target market. The 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.
- R.2.58 When the Distributor defines its Product assortment, it should take into consideration situations where it might not be able to make a thorough target

market assessment by virtue of the type of Services they provide. In such circumstances, it is most important that the Distributor takes into due consideration all relevant information provided by the Manufacturer, both in terms of target market and distribution strategy.

- R.2.59 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 Rules 2.26 to 2.29.

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

- R.2.60 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

- R.2.61 The Distributor is 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 requirement should apply in a proportionate manner depending, not only on the nature of the Product but also on the type of Services that they provide. In this regard, 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.

- R.2.62 When defining its Product assortment, the Distributor shall take into consideration situations where it might not be able to conduct a thorough target market assessment by virtue of the type of Services it provides. In particular, where the Distributor carries out only execution services with the assessment of appropriateness, it should consider that it 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; where it only conducts execution services under the execution-only regime, not even the assessment of Clients knowledge and experience will usually be possible. In this respect, Distributors should pay particular attention to the distribution strategy suggested by the Manufacturer.

- R.2.63 Rule 2.61 also applies to Products characterised by complexity/risk features, as well as for situations where there might be significant conflicts of interest, 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 the Distributor takes into due consideration all relevant information provided by the product Manufacturer, both in terms of potential target market and distribution strategy.
- R.2.64 In the case that the Client's protection decreases when information available is not sufficient to ensure a full target market assessment, the Distributor may also decide to let Clients operate on a non-advised basis after having warned them that the Regulated Person is not in the position to assess their full compatibility with such Products.
- R.2.65 Should the Distributor approach its 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

- R.2.66 The Distributor shall take into account the distribution strategy identified by the Manufacturer and review it with a critical look. When the Manufacturer is an entity not subject to the requirements of MIFID II and hence not obliged to identify a distribution strategy, the Distributor shall define its own Distribution Strategy according to the information on its Client base and type of Services provided.
- R.2.67 The Distributor can decide to follow a more prudent approach by providing investment services that afford a higher level of protection to Clients, such as investment advice. On the contrary, the Distributor can decide, in certain circumstances, to take a less prudent approach in relation to the distribution strategy defined by the Manufacturer.

Portfolio management, portfolio approach, hedging and diversification

- R.2.68 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.

- R.2.69 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).
- R.2.70 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.
- R.2.71 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.

Regular review by the Manufacturer and Distributor to respectively assess whether Products and Services are reaching the target market

- R.2.72 Manufacturers and Distributors are required to review Products on a regular basis to assess whether the Product remains consistent with the needs, characteristics and objectives of the Identified target market and whether the intended distribution strategy remains appropriate.
- R.2.73 Manufacturers should consider, on a proportionate basis, what information they need in order to complete their review and how to gather that information. Relevant information could include, for example, information on which distribution channels have been employed, the proportion of sales made outside the target market, summary information of the types of Client, a summary of any complaints received and questions suggested by the Manufacturer to a sample of Clients for feedback. Such information may be in an aggregated form and does not need to be on an instrument-by-instrument or sales-by-sales basis.
- R.2.74 The Distributor must provide the Manufacturer with information on sales and, where appropriate, any other relevant information that may be the outcome of the Distributor's own periodic review. Furthermore, the Distributor 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).

- R.2.75 In relation to the reporting of information on sales outside the Manufacturer's target market, the Distributor shall report any decisions they have taken to sell outside the target market or to broaden the distribution strategy recommended by the Manufacturer and information on sales made outside the target market (including sales within the negative target market), taking into account the exceptions as noted in paragraph 54(to include reference of rule).

Distribution of Products manufactured by entities not subject to Product Governance Requirements

- R.2.76 Distributors of Products that have not been manufactured by entities subject to the requirements of these Rules 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 requirements of these Rules.
- R.2.77 Where a Product has not been designed in accordance with the requirements of these Rules, this may affect the information gathering process or the target market identification:

[i] Target market definition: The Distributor shall determine the target market also when the target market is not defined by the Manufacturer. Therefore, even where the Regulated Person 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.

[ii] Information gathering process: The Distributor 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. Where all relevant information is not publicly available (for example, through the PRIIPs, 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.

R.2.78 The requirement referred to in Rule 2.77 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. 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.

R.2.79 Where the Distributor is not in a position to obtain in any way sufficient information on Products manufactured by entities not subject to these Rules, the Regulated Person would be unable to meet its obligations under these Rules 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.

R.2.80 Products manufactured and distributed before 3 January 2018 do not fall within the scope of the product governance requirements provided in these Rules.

R.2.81 Products which were manufactured before 3 January 2018 but which are distributed to Clients after 3 January 2018 fall within the scope of product governance requirements applicable to Distributors, in particular, the requirement to identify a target market for any financial product. In this situation, the Distributor should act as if the Manufacturer was an entity not subject to MiFID II product governance requirements. When the target market has been identified by the Manufacturer (on a voluntary basis / on the basis of commercial agreements with Distributors) in line with these guidelines, the Distributor, after reviewing it with a critical look, could rely on this target market identification.

R.2.82 A target market should be assigned by the Manufacturer to such Products, at the latest, following the next Product review process cycle that is conducted according to R.2.9, R.2.15, R.2.17 and R.2.32 after 3 January 2018. The Distributor should then consider this target market in its own review process.

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

R.2.83 The Manufacturer and Distributor shall consider whether the Product would be incompatible with certain target Clients ("negative" target market). In this respect, the Manufacturer and Distributor shall apply the same categories and principles as stated above in R.2.19 to R.2.25 and R.2.53 to R.2.58. In line with the approach followed for the identification of the 'positive' target market, the Manufacturer, who

does not have a direct relationship with end-clients, will be able to identify the negative target market on a theoretical basis, i.e. with a more general view on how the specificities of a given Product would not be compatible with certain groups of investors; the Distributor, taking into account the Manufacturer's more general negative target market as well as information on its own client base, will be in the position to identify more concretely the group of Clients to whom it should not distribute that specific Product. In addition, the Distributor is also required to identify any group(s) of Clients for whose needs, characteristics and objectives, a service related to the distribution of a certain Product would not be compatible.

- R.2.84 The Manufacturer and Distributor can define the negative target market by stating that the Product or Service is incompatible for any Client outside the positive target market, when some of the target market characteristics used in the positive target market assessment by Manufacturers and Distributors automatically lead to opposing characteristics for Clients for whom the Product is not compatible.
- R.2.85 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.
- R.2.86 There might be situations where Products could, under certain circumstances and where all other legal requirements are met (including those relating to disclosure, suitability or appropriateness, identification and management of conflicts of interest), be sold outside the positive target market. However, these instances should be justified by the individual facts of the case, the reason for the deviation should be clearly documented and, where provided, included in the suitability report.
- R.2.87 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 Clients 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.
- R.2.88 Manufacturers and Distributors shall 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. Manufacturers and Distributors shall also take into consideration the nature of the Products included in the range of those they intend to offer to Clients and the existence of any conflicts of interest with Clients (such as in the case of self-placement), as well as their business model.

- R.2.89 If the Distributor becomes aware that the sale of a certain Product outside the target market identified ex-ante has become a significant phenomenon, such input shall 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 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.
- R.2.90 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 R.2.70.

Application of the target market requirements to Manufacturers and Distributors dealing in wholesale markets (i.e. with Professional Clients and Eligible counterparties)

Professional Clients and Eligible counterparties as part of the intermediation chain

- R.2.91 The requirements set out in R.2.9, R.2.15, R.2.17 and R.2.32 apply irrespective of the nature of the Client (retail, professional or Eligible counterparty). At the same time R.2.9, R.2.15, R.2.17 and R.2.32 and R.2.6 specify that the Clients to be targeted shall be the “end-clients”. A Manufacturer and Distributor does not need to specify a target market for other Distributors (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 R.2.19 (a).
- R.2.92 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”.
- R.2.93 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.

Professional Clients and eligible counterparties as end-clients

- R.2.94 Manufacturers and Distributors are required to ensure that the Products they manufacture and/or distribute are designed to meet the needs of an Identified target market of end-clients within the relevant category of Clients. When assessing the appropriate target market for a particular Product, Regulated Persons should consider the appropriate Client category and whether it allows them to make any assumptions about the end clients’ knowledge and experience.

For Professional Clients as end-clients

- R.2.95 Manufacturers and Distributors 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. In terms of these Rules, Manufacturers and Distributors can distinguish between per se Professional Clients and elective Professional Clients – providing that Clients in the latter category should not be presumed to possess the knowledge and experience comparable to per se Professional Clients.
- R.2.96 When carrying out their target market identification, Manufacturers and Distributors shall 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.

For eligible counterparties as end-clients

- R.2.97 Manufacturers and Distributors are required to ensure that they act honestly, fairly and professionally” and communicate in a way that is “fair, clear and not misleading” in their dealings with eligible counterparties.
- R.2.98 Where the target market of end-clients is composed solely of Eligible counterparties, the overall assessment is likely to be less comprehensive. Eligible counterparties will be likely to have a detailed understanding of the market environment, commercial viability and other key factors and risks associated with a particular investment decision.
- R.2.99 Manufacturers and Distributors shall have in place adequate Product governance arrangements to ensure that Products and Services they intend to offer or recommend are compatible with the needs, characteristics, and objectives of an Identified target market and that the intended distribution strategy is consistent with the Identified target market. Regulated Persons shall appropriately identify and assess the circumstances and needs of the Clients they intend to focus on, so as to ensure that Clients' interests are not compromised as a result of commercial or funding pressures. As part of this process, Manufacturers and Distributors shall identify any groups of Clients for whose needs, characteristics and objectives the Product or Service is not compatible. Distributors shall obtain from Manufacturers that are subject to these Rules information to gain the necessary understanding and knowledge of the Products they intend to recommend or sell in order to ensure that these Products will be distributed in accordance with the needs, characteristics and objectives of the Identified target market.

Manufacturers and Distributors shall take all reasonable steps to ensure they also obtain adequate and reliable information from Manufacturers not subject to these

Rules to ensure that Products will be distributed in accordance with the characteristics, objectives and needs of the target market. Where relevant information is not publicly available, the Distributor shall take all reasonable steps to obtain such relevant information from the Manufacturer or its agent. Acceptable publicly available information is information which is clear, reliable and produced to meet regulatory requirements, such as disclosure requirements under Directive 2003/71/EC or 2004/109/EC. This obligation 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 obtainable and the complexity of the Product.

Manufacturers and Distributors shall use the information obtained from Manufacturers and information on their own Clients to identify the target market and distribution strategy. When a Regulated Person acts both as a Manufacturer and a Distributor, only one target market assessment shall be required.

- R.2.100 Manufacturers and Distributors shall, when deciding the range of Financial Instrument and Services that they offer or recommend and the respective target markets, maintain procedures and measures to ensure compliance with all applicable requirements under these Rules including those relating to disclosure, assessment of suitability or appropriateness, inducements and proper management of conflicts of interest. In this context, particular care shall be taken when Distributors intend to offer or recommend new Products or there are variations to the Services they provide.
- R.2.101 Manufacturers and Distributors shall review the Financial Instruments they offer or recommend and the Services they provide on a regular basis, taking into account any event that could materially affect the potential risk to the Identified target market. Manufacturers and Distributors shall assess at least whether the Product or Service remains consistent with the needs, characteristics and objectives of the Identified target market and whether the intended distribution strategy remains appropriate. Manufacturers and Distributors shall reconsider the target market and/or update the product governance arrangements if they become aware 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.
- R.2.102 Manufacturers and Distributors shall ensure that relevant staff possess the necessary expertise to understand the characteristics and risks of the Products that they intend to offer or recommend and the Services provided as well as the needs, characteristics and objectives of the Identified target market.

- R.2.103 Manufacturers and Distributors shall ensure that the Management body has effective control over the Manufacturer and Distributor's product governance process to determine the range of Financial Instruments that they offer or recommend and the Services provided to the respective target markets. Manufacturers and Distributors shall ensure that the compliance reports to the Management body systematically include information about the Financial Instruments they offer or recommend and the Services provided. The compliance reports shall be made available to the MFSA on request.
- R.2.104 Manufacturers and Distributors shall ensure their compliance function oversee the development and periodic review of product governance arrangements in order to detect any risk of failure to comply with the obligations set out in these Rules.
- R.2.105 Distributors shall provide Manufacturers with information on sales and, where appropriate, information on the above reviews to support Product reviews carried out by Manufacturers.
- R.2.106 Where different Manufacturers and Distributors work together in the distribution of a Product or Service, the Manufacturer and Distributor with direct Client relationship shall have ultimate responsibility to meet the product governance obligations set out in these Rules. However, intermediary Regulated Persons shall:
- (a) Ensure that relevant Product information is passed from the Manufacturer to the final Distributor in the chain;
 - (b) If the Manufacturer requires information on Product sales in order to comply with their own product governance obligations, enable them to obtain it; and
 - (c) Apply the product governance obligations for Manufacturers, as relevant, in relation to the Service they provide.

Part C: Rules applicable to Manufacturers and Distributors of Structured Products whose target market are Retail Clients.

Product Testing Obligations in relation to Structured Products

- R.2.107 A Manufacturer of Structured Products shall:
- a) Consider the characteristics, especially the risk characteristics, of the Structured Product, such as illiquidity and riskiness of the underlying asset(s) and shall have an understanding of the model and input parameters as well as the assumptions built into the valuation of the Structured Product;
 - b) Back test Structured Products, such that the Manufacturer may understand how it would have performed in the past;

c) Undertake simulations of future performance scenarios to assess whether likely outcomes of the Structured Product would meet the investment objectives of the identified target market;

d) Ensure that risk management methods used are consistent with the manufacturer's internal risk management framework. Testing should consider extreme economic environments (stress testing) and to include quantitative assessments of external (primarily financial) risks;

e) Make available the results of tests and scenarios to distributors.

R.2.108 A Distributor of Structured Products shall ensure that it is aware and understands the results of the tests as well as the simulations of performance scenarios undertaken by the manufacturer. The distributor, should at minimum, adopt adequate arrangements to examine critically those results and scenarios and if needed employ an independent third-party with the relevant expertise.

Modelling and statistical test analysis to be used when designing Structured Products

R.2.109 Prior to the issue of a Structured Product, the Manufacturer shall conduct robust, unbiased and arbitrage-free testing as to allow for an external party to adequately challenge the Structured Product's pricing, valuation and risk/reward trade-off relative to the identified target market.

Distribution Strategy in relation to Structured Products

R.2.110 A Manufacturer of Structured Products shall adopt appropriate policies and procedures regarding its relationships with the Distributors it appoints. Such policies and procedures should also cover the provision to distributors of sufficiently detailed information about the Structured Products' pay-off structure, the model, valuation methods and the Structured Product risk / return scenarios.

R.2.111 When receiving information provided by a Manufacturer of Structured Products, the Distributor shall:

a) Consider, when providing the information provided by the Manufacturer to clients, whether they understand the information included;

b) Ask the Manufacturer to supply additional information or training where that seems necessary to understand the Structured Product adequately.

Part D: Rules applying to Regulated Persons falling under points (iii) and (iv) of the Definition of 'Regulated Person' in the Glossary

R.2.112 A Regulated Person shall be considered a Manufacturer where an overall analysis of its activity shows that it has a decision-making role in designing and developing a Product for the market.

Regulated Persons falling under point (iv) of the definition of 'Regulated Person' in the Glossary shall be deemed to have a decision-making role when such Regulated Person autonomously determines the essential features and main elements of the Product, including its coverage, price, costs, risk, target market and compensation and guarantee rights, which are not substantially modified by the insurance undertaking providing coverage for the Product.

Personalisation of and adaptation of existing Products in the context of distribution activities for individual Clients, as well as the design of tailor-made contracts at the request of a single Client, shall not be considered manufacturing.

Regulated Persons falling under points (iii) and (iv) of the definition of 'Regulated Person' in the Glossary, that are both manufacturers shall sign a written agreement which specifies their collaboration to comply with the requirements for Manufacturers provided in these Rules, the procedures through which they shall agree on the identification of the target market and their respective roles in the product approval process.

Establishment of the Product Governance and Oversight Arrangements by a Manufacturer

R.2.113 A Manufacturer should establish and implement Product Governance and Oversight Arrangements that set out appropriate measures and procedures aimed at designing, monitoring, reviewing and distributing Products for Clients, as well as taking action in respect of Products that may lead to detriment to Clients.

R.2.114 The Product Governance and Oversight Arrangements shall be proportionate to the level of complexity and the risks related to the Products as well as the nature, scale and complexity of the relevant business of the Manufacturer.

Objectives of the Product Governance and Oversight Arrangements

R.2.115 The Product Governance and Oversight Arrangements shall

(a) Ensure that the design of Products meet the following criteria:

(i) It takes into account the objectives, interests and characteristics of clients;

(ii) It does not adversely affect clients;

(iii) It prevents or mitigates client detriment;

(b) Support a proper management of conflicts of interest.

G.2.6 The Product Governance and Oversight Arrangements which the Manufacturer develops, may vary depending on the Product or Service or line of business, as applicable, in accordance with the principle of proportionality taking into consideration the nature, scale and complexity of the relevant business of the manufacturer and the complexity of the Product. The Product Governance and Oversight Arrangements needs to be appropriate to account for risks borne by Clients for a Product.

G.2.7 Product Governance and Oversight Arrangements are without prejudice to basic principles in insurance, in particular the principle of solidarity and mathematical methods. The interest of Clients that must need to be taken into account when designing products following the Product Governance and Oversight Arrangements comprise individual and collective policyholder interests which need to be duly balanced.

Role of the Management body

R.2.116 The Manufacturer's Management body responsible for the manufacturing of Products shall endorse and be ultimately responsible for the establishment, implementation, and subsequent reviews of the product approval process. The Manufacturer's Management body shall continuously verify internal compliance with the product approval process.

R.2.117 The Manufacturer's Management body shall ensure that it has effective control over the Manufacturer's governance process in order to ensure effective oversight and control over the product design and manufacture process.

R.2.118 The Manufacturer shall ensure that the compliance reports to the Management body systematically include information about the Products manufactured by the Manufacturer, including information on the distribution strategy. The Manufacturer shall make the reports available to the MFSA upon request.

G.2.8 The Manufacturer's Management body ensures that the Product Governance and Oversight Arrangements is appropriately designed and implemented into the governmental structures of the Manufacturer. This Rule clarifies that the ultimate responsibility for the procedures and measures lies with the top management of an entity.

G.2.9 The Manufacturer's Management body can consider involving any relevant functions in the establishment and subsequent reviews of the Product Governance and Oversight Arrangements.

G.2.10 The Product Governance and Oversight Arrangements as well as any changes are subject to prior approval by the Manufacturer's Management body.

Review of Product Governance and Oversight Arrangements

R.2.119 The Manufacturer shall regularly review the Product Governance and Oversight Arrangements to ensure that they are still valid and up to date and the Manufacturer shall amend it where necessary.

G.2.11 A minimum frequency for regular review and updates is to be established. In addition, relevant factors are to be identified which – once they occur – could trigger an ad hoc review of the Product Governance and Oversight Arrangements. Such factors could be, for example, significant changes in the retail strategy, changes in the complexity of the product lines and changes in the distribution channels.

G.2.12 Any review of the Product Governance and Oversight Arrangements has to be appropriately documented. The documentation needs to record who conducted the review and to include any suggested recommendations and the decisions subsequently taken by the Manufacturer's Management body in respect of those recommendations as well as the reasons for them.

Target market

R.2.200 The product approval process shall for each Product identify the target market and the group of compatible Clients. A Manufacturer shall include in its Product Oversight and Governance Policy suitable steps in order to identify at a sufficiently granular level the potential relevant target market of each product and specify the type(s) of Client for whose needs, characteristics, risk profile, complexity, nature and objectives the Product is compatible.

R.2.201 A Manufacturer may, in particular with regard to insurance-based investment products, identify group of Clients for whose needs, characteristics and objectives the Product is generally not compatible.

R.2.202 A Manufacturer shall only design and market, Products that are compatible with the needs, characteristics and objectives of the Clients belonging to the target market. When assessing whether a Product is compatible with a target market, the Manufacturer shall take into account the level of information available to the clients belonging to that target market and their financial literacy.

R.2.203 A Manufacturer may, in particular with regard to insurance-based investment products, identify group(s) of Clients for whom the Product is considered likely not to be aligned with their, needs, interests, objectives and characteristics.

G.2.13 To identify the target market, a Manufacturer should not solely rely on quantitative criteria but needs to sufficiently balance them with qualitative considerations

G.2.14 To identify the target market, a Manufacturer can consider the following:

- a) tax status implications for different Products;*
- b) level of risks of the Product to be designed;*
- c) insurance coverage and exclusions;*
- d) liquidity accessibility;*
- e) demographic factors;*
- f) level of knowledge and understanding of the complexity of the Product;*
- g) financial capability.*

G.2.15 When identifying the target market, the Manufacturer needs to consider the charges and risks that Products may present and consider if they are compatible for the Identified target market.

G.2.16 Moreover, in certain cases it may be rather obvious for whom the Product would not be suitable (e.g. a life insurance policy running for 30 years for a 97 year old woman). Therefore, identifying for whom the product may not be suitable is helpful in order to get a clear picture of the boundaries of the target market.

G.2.17 The identification of the target market is crucial to enable Distributors to understand to whom the Product can be sold.

G.2.18 It is recommended that as necessary, the staff involved in designing Products receives, for instance, appropriate professional training to understand the characteristics and risks of the relevant Products and the interests, objectives and characteristics of the target market.

Product testing

R.2.204 Before a Product is brought to the market, or if the target market has changed significantly or significant changes to an existing Product are introduced, a Manufacturer shall conduct appropriate testing of the Product including, if relevant, scenario analyses.

R.2.205 The Product testing shall assess if the Product over its lifetime meets the identified needs, objectives and characteristics of the target market over the lifetime of the Product. The Manufacturer shall test the Product in a qualitative manner and, depending on the type and nature of the Product and the related risk of detriment to clients, quantitative manner.

R.2.206 A Manufacturer shall not bring a Product to the market if the results of the Product testing show that the Product is not aligned with the identified needs, objectives and characteristics of the target market.

R.2.207 A Manufacturer shall carry out Product testing in qualitative and, where appropriate, in quantifiable manner depending on the type and nature of the Product and the related risk of detriment to Clients.

G.2.19 *When testing a Product, Manufacturers need to consider all significant risks to which Clients subscribing to that Product would be exposed to in order to align the Product with the interest of the target market.*

G.2.20 *For instance, Manufacturers need to make appropriate Product changes before the launch, where the Product testing and/or scenario analysis gives rise to poor results for the target market.*

G.2.21 *The range of scenario analysis needs to be proportionate to the complexity of the Product, its risks and the relevance of external factors with respect to the Product performance.*

G.2.22 *Keeping in mind the objectives of the defined target market, the assessment may consider the following questions:*

- a) What if assumptions change, for instance if market conditions deteriorate?*
- b) Is the price of the policy in balance with the worth of the underlying? For instance, is it possible to close an all-risk policy for an old car?*
- c) What if certain circumstances during the lifetime of the Product change? For instance, what happens with the premium of unemployment insurance if a person gets unemployed, disabled or experiences other life events? What are the consequences for the coverage of a payment protection insurance product when a married couple divorces?*
- d) What happens to the (guaranteed) coverage (insured amounts) of my fire and theft insurance when my income changes?*

G.2.23 *In addition to the questions above, more specifically for insurance-based investment products, the assessment may consider also the following questions:*

- a) What would happen to the risk and reward profile of the product following changes to the value and liquidity of underlying assets?*
- b) How is the risk/reward profile of the product balanced, taking into account the cost structure of the product?*
- c) When a product benefits from a certain tax environment or other condition; what happens if these conditions change?*

- d) *What are the terms and conditions, and how do they affect the outcome of the product?*
- e) *What will happen when the manufacturer faces financial difficulties?*
- f) *What will happen if the customer terminates the contract early?*

G.2.24 *In addition to the questions above, more specifically for pure protection life insurance products, the assessment may consider also the following questions:*

- a) *What if the premises change, for instance mortality rate increases, or technical interest rate increases?*
- b) *Does the benefit cover sufficiently future needs of beneficiary?*

In the case of a non-life insurance, the assessment may consider the following questions:

- a) *What is the expected claims ratio and the claims payment policy? What if it is higher or lower than expected? Do the expected claims ratio and claims payment policy suggest that the product is of monetary benefit to customers?*
- b) *Does the coverage of one product potentially overlap with the coverage of another product?*
- c) *Does the coverage meets sufficiently future needs of target market? How is the coverage updated in terms of reflecting future needs of target market?*
- d) *Do customers understand the terms and limitations of the contract?*
- e) *Would the manufacturer be able to cope with a large amount of customers? Is the amount of staff sufficient enough to deal with a large amount of requests from customers?*

G.2.25 *The Manufacturer of an insurance-based investment product will in the future be required to produce an Insurance Product Information Document (IPID) containing information on the risk and reward profile of the Product. Performance scenarios expected to be presented in the IPID and the range of scenarios used for testing the product may present similarities; however may not necessarily be identical. Performance scenarios are disclosed to customers whereas scenarios for testing the products cover a large range of factors that determine the performance of the Product.*

Product Monitoring

R.2.208 A Manufacturer shall continuously monitor and regularly review Products brought to the market, to identify events that could materially affect the main features, the risk coverage or the guarantees of those Products. The Manufacturer shall assess whether the Products remain consistent with the needs, characteristics and

objectives of the Identified target market and whether those Products are distributed to the target market or is reaching Clients outside the target market.

R.2.209 A Manufacturer shall determine the appropriate intervals for the regular review of Products, thereby taking into account the size, scale, contractual duration and complexity of those Products, their respective distribution channels, and any relevant external factors such as changes to the applicable legal rules, technological developments, or changes to the market situation.

R.2.210 A Manufacturer that identifies during the lifetime of a Product any circumstances related to the Product that may adversely affect the Client of that Product shall take appropriate action to mitigate the situation and prevent further occurrences of the detrimental event. The Manufacturer shall promptly inform concerned Distributors and Clients about the remedial action taken.

G.2.26 As part of the Product monitoring process, a Manufacturer takes into account for example the level of the claims ratio for the Product as well as claims payment policy or causes of complaints in determining whether to revise the offering.

G.2.27 For instance, the claims ratio or cause of complaints could be used as a tool to assess whether certain Products are of good value to customers. These are two tools which indicate whether customers are getting a fair deal (value for money).

Remedial action

R.2.211 Should the Manufacturer identify, during the lifetime of a Product, circumstances which are related to the Product and give rise to the risk of Client detriment, the Manufacturer shall take appropriate action to mitigate the situation and prevent the re-occurrence of detriment.

R.2.212 If relevant, the Manufacturer shall notify any relevant remedial action promptly to the Distributors involved and to the Client.

G.2.28 A Manufacturer needs to take appropriate action whenever he becomes aware that the Product might cause detriment to Clients. This might be the case during the regular Product monitoring exercise, but also when he is, for instance, informed by the Distributor or through a complaint.

G.2.29 The Product lifetime is understood as capturing the entire life cycle of a Product which begins at the moment when the Product is being designed and only finishes once there is no Product left on the market. It covers situations when the Product is no longer being sold but there are still Clients who own the Product. The end of the life cycle of the Product is reached only when the last Product has been withdrawn from the market.

G.2.30 *For example, remedial action needs to be taken when the Product no longer meets the general needs of the target market or when the Product performance is significantly different (in terms of detriment to the Client) from what the Manufacturer originally expected.*

G.2.31 *As a general rule, the Manufacturer can only make changes to the Product that are consistent with the interests, objectives and characteristics of the already existing target market and these changes do not have an adverse impact on the Client to which the Product has been sold already.*

G.2.32 *In order to prevent Client detriment efficiently, it might also be necessary that the Manufacturer notifies the remedial action taken to the Distributors involved and to the Clients. This might be the case where the risk profile of a Product has changed due to market developments and the Product is no longer in line with the interests, objectives and characteristics of the target market.*

Distribution channels

R.2.212 A Manufacturer of Products shall adopt appropriate policies and procedures, which shall be in writing and reviewed periodically, regarding its relationships with the Distributors it appoints. Such policies and procedures should as a minimum cover the following:

- a) Criteria and procedures governing the choice of those Distributors;
- b) Roles and responsibilities of the different parties;
- c) Provision of information to assist Distributors in identifying conditions when Products should not be distributed to a group of Clients as referred to in R.2.200 to R.2.203 or to the Identified target market;
- d) Flagging of key risks and returns.

R.2.213 A Manufacturer shall carefully select distribution channels that are appropriate for the target market, thereby taking into account the particular characteristics of the relevant Product.

R.2.214 A Manufacturer shall provide to Distributors with all appropriate information on the Product, the Identified target market and the suggested distribution strategy, including information on the main features and characteristics of the Products, their risks and costs, including implicit costs, and any circumstances which might cause a conflict of interest to the detriment of the Client. That information shall be clear, complete and up-to-date.

R.2.215 The information given to Distributors shall be sufficient to enable them to:

- a) Understand the Products;
- b) Comprehend the Identified target market for the Products;
- c) Identify any Clients for whom the Product is not compatible with their needs, characteristics and objectives;
- d) Carry out distribution activities for the relevant Products in accordance with the best interests of their Clients.

R.2.216 The information which a Manufacturer supplies to the Distributor shall not substitute the suitability assessment and the specification of the demands and needs of a specific Client and the underlying reasons for any advice given by the Distributor.

R.2.217 A Manufacturer shall take all reasonable steps to ensure that distribution channels act in compliance with the objectives of the Manufacturer's Product Governance and Oversight Arrangements.

R.2.218 A Manufacturer shall take appropriate steps to monitor that Distributors act in accordance with the objectives of the Manufacturer's product approval process. They shall in particular verify on a regular basis whether the Product is distributed on the Identified target market. That monitoring obligation shall not extend to the general regulatory requirements with which Distributors have to comply when carrying out distribution activities for individual Clients. The monitoring activities shall be reasonable, taking into consideration the characteristics and the legal framework of the respective distribution channels.

R.2.219 When the Manufacturer considers that the distribution channel does not meet the objectives of the Manufacturer's Product Governance and Oversight Arrangements, the Manufacturer shall take remedial actions towards the distribution channel.

G.2.33 A Manufacturer needs to select Distributors that have the necessary knowledge, expertise and competence to understand the Product features and the characteristics of the Identified target market, correctly place the Product in the market and give the appropriate information to Clients.

G.2.34 A Manufacturer's information to the Distributor does not seek to substitute the specification of the demands and needs of a specific Client and the underlying reasons for any advice given by the Distributor according to Article 12(3) of Directive 2002/92/EC.

G.2.35 A Manufacturer informs the Distributor about who is the target market that the Product has been designed for.

G.2.36 Manufacturers may survey a number of Clients to find out if they understood the Product features and to see if they fit into the target market. If they do not, then the Manufacturer needs to consider what this means – is its information material

adequate? Is it providing enough information to Distributors? Is it working right with the Distributors?

G.2.37 If the Manufacturer identifies problems with the selected distribution channels, (i.e. when the Distributor is offering the Product to Clients for whom it is not compatible) they need to take appropriate actions. In the case of independent Distributors, Manufacturers might, for instance, need to consider ceasing making available the relevant Products to the Distributor not meeting the Product Governance and Oversight objectives of the Manufacturer.

Outsourcing of the product design

R.2.220 A Manufacturer shall retain full responsibility for compliance with Product Governance and Oversight Arrangements as described in these Rules when it designates a third party to design products on their behalf.

Documentation of Product Governance and Oversight Arrangements

R.2.221 Relevant actions taken by the Manufacturer in relation to the Product Governance and Oversight Arrangements shall be duly documented, kept for audit purposes and made available to the MFSA upon request.

G.2.38 Without prejudice to local legislation it is recommended that the records of the relevant documentation are kept in a durable medium for a minimum period of five years. The period starts when the relevant action is taken. There might be situations where it is appropriate to keep the documentation for a longer period of time, e.g. due to the lifetime of a Product.

Establishment of product distribution arrangements

R.2.222 A Distributor shall establish and implement product distribution arrangements that set out appropriate measures and procedures to obtain from the Manufacturer all appropriate information on the Products for considering the range of Products and Services the Distributor intends to offer to its Clients, to fully comprehend those Products, taking into account the level of complexity and the risks related to the Products as well as the nature, scale and complexity of the relevant business of the Distributor. For reviewing the product distribution arrangements and for obtaining all necessary information on the Product(s) from the Manufacturer(s).

R.2.223 The product distribution arrangements need to be proportionate to the level of complexity and the risks related to the Products as well as the nature, scale and complexity of the relevant business of the Regulated Person.

R.2.224 The Distributor shall set out the product distribution arrangements in a written document and make it available to its relevant staff.

Objectives of the Product Distribution Arrangements

- R.2.225 The product distribution arrangements shall aim to prevent and mitigate Client detriment, support a proper management of conflicts of interests and shall ensure that the objectives, interests and characteristics of Clients are duly taken into account.
- G.2.39 *R.2.222 to R.2.225 set out the general principle that Distributors need to establish appropriate measures and procedures with regard to the Products they intend to distribute. In contrast with the Rules applicable for Manufacturers, the focus of the Rules applicable to Distributors is not on the design and subsequent review of the Products, but on the necessary steps in preparation of the distribution of the Products to the Clients (such as obtaining all relevant information from the Manufacturer and defining a distribution strategy).*
- G.2.40 *The Rules acknowledge the importance of establishing adequate processes before Products are distributed to Clients. Already at this stage Distributors need to consider to which extent the Product choice gives rise to the risk of conflicts of interest and if so, which measures should be taken in order to ensure that the distribution activities are carried out in accordance with the best interest of the Clients. This might also imply that Distributors abstain from distributing specific Products, for example in cases where Products do not offer any value to the Client, but only a high commission to the Distributor. The Rules are not intended to mean that the Distributor should make a previous selection of Products or that the Distributor should identify its own target market.*
- G.2.41 *The Rules generally apply to all insurance distributors, including any natural or legal person pursuing the activity of insurance distribution, independent from the question whether these activities are pursued as a principal professional activity or on an ancillary basis, by an independent broker or by a tied agent.*
- G.2.42 *The Rules for Distributors provide a separate set of Rules with specific duties and responsibilities for Distributors to be distinguished from those applicable to Manufacturers. The Rules for Distributors do not aim to extend and transfer the responsibilities of Manufacturers vis-à-vis their Products, but to establish a distinct set of duties Distributors should comply with when selecting products for distribution.*

Role of Management body

- R.2.225 The Distributor's Management body responsible for the distribution shall endorse and be ultimately responsible for establishing, implementing, reviewing the product distribution arrangements and continuously verify internal compliance with those arrangements.

G.2.43 R.2.225 is primarily aimed at entities where the tasks related to the product distribution arrangements are delegated either internally or even externally (e.g. in cases of outsourcing) and clarifies that the ultimate responsibility for the organisational measures and procedures lies with the top management of the Distributor.

Obtaining all necessary information on the target market from the Manufacturer

R.2.226 The product distribution arrangements shall aim to ensure that the Distributor obtains all necessary information from the Manufacturer to be communicated under R.2.214.

G.2.44 An important prerequisite to setting up a distribution strategy as required under R.2.228 is that the Distributor has detailed knowledge about the approval process of the Manufacturer, in particular the target market of the individual Product. This information helps the Distributor to select the Products the Distributor intends to distribute and to assess to which Clients the Distributor may advertise and promote the individual Products.

Obtaining all other necessary information on the Product from the Manufacturer

R.2.227 The product distribution arrangements shall aim to ensure that the Distributor obtains all other necessary information on the Product from the Manufacturer in order to fulfil its regulatory obligations towards the Clients. This includes information on the main characteristics of the Products, its risks and costs as well as circumstances which may cause a conflict of interests at the detriment of the Client.

G.2.45 This Rule complements R.2.226 and requires the Distributor to establish appropriate arrangements to obtain from the Manufacturer all relevant information on the Product which is necessary to carry out its distribution activities. The purpose of this Rule is to ensure that the Distributor receives all Product related information about which the Distributor is required to inform the Clients.

Distribution strategy

R.2.228 Where the Distributor sets up or follows a distribution strategy it shall not contradict the distribution strategy and the target market identified by the Manufacturer of the Product.

G.2.46 The distribution strategy addresses the question on how Products are distributed to Clients. The distribution strategy needs to consider aspects such as whether the Product should only be sold with advice, or if the Product should be made available only to particular groups in the Regulated Person's Client bank.

- G.2.47 R. 2.228 emphasises that in cases where the Distributor sets up or follows an own distribution strategy, this strategy needs to be consistent with the target market identified by the Manufacturer of the respective Product. In particular, this means that the distribution strategy generally does not allow that the Products are distributed to Clients which are not part of the target market identified by the Manufacturer of the respective Product. The distribution strategy may also outline circumstances under which the distribution of Products to Clients outside of the target market is permitted exceptionally.*
- G.2.48 If the Distributor can justify and demonstrate that the Product fits with the best interest of the relevant Client, the Distributor may exceptionally distribute Products to a Client, who is outside of the target market identified by the Manufacturer. In these exceptional cases, the Distributor has to duly document this in accordance with R.2.231.*
- G.2.49 This Rule applies without prejudice to any assessment of demands and needs, suitability or appropriateness to be subsequently carried out by the Distributor when providing services to the individual Client at the point of sale.*

Regular review of product distribution arrangements

R.2.229 The Distributor shall regularly review the product distribution arrangements to ensure that those arrangements are still valid and up to date and shall amend them where appropriate. The Distributor that have set up or apply a specific distribution strategy shall, where appropriate, amend that strategy in view of the outcome of the review of the product distribution arrangements. When reviewing the product distribution arrangements, the Distributor shall verify that the Product is distributed to the Identified target market.

The Distributor shall determine the appropriate intervals for the regular review of their product distribution arrangements, thereby taking into account the size, scale and complexity of the different Products involved.

To support Product reviews carried out by the Manufacturer, the Distributor shall upon request provide the Manufacturer with relevant sales information, including, where appropriate, information on the regular reviews of the product distribution arrangements.

- G.2.50 As the product distribution arrangements are an important element to prevent and mitigate detriment to the Clients, it seems appropriate that Distributors regularly review whether their arrangements are still valid and up to date. This applies in particular with regard to the distribution strategy for each Product taking into consideration that the target market (as initially identified by the Manufacturer) may*

be redefined in the course of time due to external factors (such as market developments).

Provision of sale information to the Manufacturer

R.2.230 The Distributor shall inform the Manufacturer without undue delay when he becomes aware that the Product is not aligned with the interests, objectives and characteristics of the Identified target market or if he becomes aware of other Product related circumstances that may adversely affect the Client. The Distributor shall, where appropriate, amend the distribution strategy for that Product.

G.2.51 *R.2.230 pursues the objective to enhance the exchange of information between Manufacturer and Distributor to facilitate the market monitoring of the Manufacturer. This does not mean that the Distributors need to periodically report every sale to Manufacturers, or that the Manufacturer must confirm each transaction was distributed to the correct target market. Ad hoc information could include, for example, information about the amount of sales made outside the target market, summary information on the Clients or a summary of the complaints received with regard to a specific Product. The obligation to provide sales data shall aim to enable the Manufacturer to monitor the Product and to check that the Product remains consistent with the needs, characteristics and objectives of the target market as defined by the Manufacturer itself.*

G.2.52 *R.2.230 is in line with R.2.208 to R.2.210 requiring the Manufacturer to monitor on an on-going basis that the Product continues to be aligned with the interests, objectives and characteristics of the target market.*

Documentation

R.2.231 Relevant actions taken by the Distributor in relation to the product distribution arrangements should be duly documented, kept for audit purposes and made available to the MFSA on request.

G.2.53 *Without prejudice to national law, it is recommended that the records of the relevant documentation are kept in a durable medium for a minimum period of five years. The period starts when the relevant action is taken. There might be situations where it is appropriate to keep the documentation for a longer period of time, e.g. due to the lifetime of a Product.*

G.2.54 *As part of the action required under R.2.231, the Distributor shall also document that he has received all necessary information from the Manufacturer according to R.2.226 and R.2.227.*

