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PRODUCT OVERSIGHT AND GOVERNANCE (POG) REQUIREMENTS

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Table of Abbreviations

CFD	Contract for Difference
EBA	European Banking Authority
EIOPA	European Insurance and Occupational Pensions Authority
ESAs	European Supervisory Authorities
ESMA	European Securities and Markets Authority
ETFs	Exchange Traded Funds
EU	European Union
IDD	Insurance Distribution Directive
JST	Joint Supervisory Team
MiFID	Markets in Financial Instruments Directive
MFSA	Malta Financial Services Authority
POG	Product Oversight and Governance
SMEs	Small and Medium-sized Enterprises
UCITS	Undertakings for the Collective Investment in Transferable Securities

Introduction

Product Oversight Requirements – An Overview

The design of financial products manufactured by financial services providers and the way such products are distributed have a significant impact on client outcome. Accordingly, it is important that financial service providers factor in the best interests of their prospective clients when designing and manufacturing products. Distributors must, *inter alia*, ensure that they are distributing the right products to the right clients. It is only in this way that positive client outcomes for financial products available on the market are maximised. To this end, requirements for Product Oversight and Governance ('POG') have been established at European Union ('EU') level. Due to their relevance in terms of client protection, it is of utmost importance that these requirements are properly implemented and applied. National authorities regulating financial services must ensure that these requirements are being observed by the entities subject to their supervision.

The 'Joint Committee' forum, composed of the European Banking Authority ('EBA'), the European Insurance and Occupational Pensions Authority ('EIOPA') and the European Securities and Markets Authority ('ESMA'), collectively referred to as the European Supervisory Authorities ('ESAs'), in 2013 issued a joint position on POG processes within financial sector entities. This joint position paved the way for the ESAs to develop further regulatory work within their respective areas of competence to address some of the causal drivers of the retail conduct failure of financial sector entities as manufacturers and distributors of banking, payments, insurance and investment products.

Ever since, the ESAs have been assessing the extent to which clients across the banking, payments, insurance and securities markets have experienced, or are at the risk of experiencing, detriment as a result of failures of product manufacturers and distributors in the development and marketing of their products and services.

The Malta Financial Services Authority ('MFSA' or 'the Authority'), is following those initiatives, assessing the extent to which potential or actual client detriment has arisen as a result of manufacturers and distributors activities in the insurance and investment products sectors. This supervisory work which has been carried out is primarily linked with the transposition and implementation of the Insurance Distribution Directive ('IDD'), the Markets in Financial Instruments Directive ('MiFID') and the EBA Guidelines on POG arrangements for retail banking products.

In December 2017, the MFSA launched its Conduct of Business Rulebook with a dedicated Chapter on Financial Product Governance applicable to investment firms, insurance undertakings and intermediaries.

The MFSA's Supervisory Work on POG

The MFSA is strongly committed to ensure that the ESA's client protection requirements are consistently implemented by its regulated entities in the financial services sector. Set as a priority for 2020, an extensive supervisory exercise on POG was undertaken to understand if regulated entities have proper POG arrangements in place.

The MFSA supervisory work on POG is following three main workstreams, namely:

- i. Assessing the state of play of the implementation of POG requirements through a cross-sector thematic review exercise;
- ii. Participating in ongoing supervisory work on POG carried out by ESAs; and
- iii. Extending the MFSA's Conduct Business Rulebook requirements, including POG requirements, to other sectors of the financial services industry.

Recently, the MFSA has carried out a cross-sectoral thematic review in the areas of credit and financial institutions, insurance undertakings and intermediaries and investment firms with a view to assess adherence to the POG requirements applicable to them. Through this exercise, the Authority analysed the responses received from the self-assessment questionnaires of around 100 regulated entities and reviewed the ongoing practices of 23 entities through focused onsite inspections. The Authority identified good practices as well as practices that would need to be improved to ensure that the Conduct of Business Rulebook and European Guidelines on POG are complied with.

Scope, Purpose and Structure of this Publication

This document is addressed to investment firms, insurance undertakings and intermediaries, credit and financial institutions regulated by the MFSA. Its purpose is to provide details of the Authority's findings pursuant to the abovementioned thematic review and to include examples of good practices (i.e. work practices that are considered to be aligned with the EBA Guidelines and MFSA Conduct of Business Rules). This is covered in Section 1 of this Document. Section 2 sets out the Authority's expectations regarding some of the observations for the different entities reviewed i.e. Credit and Financial Institutions, Insurance Undertakings and Intermediaries and Investments Service Providers with respect to five main elements of POG requirements: (i) Internal Governance Arrangements (ii) Target Market (iii) Product Testing (iv) Monitoring and Remedial Actions and (v) Distribution and Information Exchange with distributors.

Section 1 - A Cross Sectoral Thematic Review on Product Oversight and Governance Requirements

1.1 Purpose of the Review

The aim of the cross-sectoral thematic review exercise was to ensure that the financial services providers subject to this review, had the POG policies and arrangements in place in line with the requirements as prescribed in the MFSA Conduct of Business Rulebook and in the European regulatory framework.

The main achievements expected from this exercise were:

- Providing additional guidance towards consistent standards across sectors and entities in each specific sector and supporting the extension of the Conduct of Business Rulebook to other Maltese financial sector entities.
- Strengthening the protection of clients in Malta by identifying and addressing potential retail conduct failures or mis-selling practices across sectors through ensuring that financial services providers have POG policies and arrangements in place which they would be required to follow in the design of new products, and, in the case of insurance manufacturers and credit institutions, a significant adaptation of their existing products.

1.2 POG Requirements – Scope

POG requirements apply to manufacturers and distributors of retail financial service products. Requirements mainly target the designing, manufacturing, and monitoring of products life cycle distributed to retail clients. POG arrangements are applicable to investment firms, insurance undertakings, insurance intermediaries, tied agents, credit institutions and financial institutions.

In the context of credit institutions, the scope was extended to identify practices and arrangements currently in place when manufacturing and distributing retail banking and payment products targeting not just personal clients but also micro-enterprises or SMEs.

POG requirements apply to all new retail financial products or services brought to the market as well as, in the case of insurance products and those issued by credit institutions and financial institutions, to existing retail financial products and services on the market which require significant adaptation.

1.3 The Applicable Regulatory Framework

With respect to Investment Firms, the requirements relating to POG emanate from MiFID and the Commission Delegated Directive (EU) 2017/593 supplementing MiFID with regard to the safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits. In order to supplement these provisions, ESMA has also issued the ESMA Guidelines on MiFID II Product Governance Requirements¹. These Guidelines, as well as the abovementioned EU legislation, have been incorporated in Chapter 2 of the Conduct of Business Rulebook.

With respect to Insurance Undertakings and Insurance Intermediaries, the requirements relating to POG emanate from the IDD as supplemented by Commission Delegated Regulation (EU) 2017/2358 of 21 September 2017 supplementing Directive (EU) 2016/97 of the European Parliament and of the Council with regard to product oversight and governance requirements for insurance undertakings and insurance distributors. In order to supplement these provisions, EIOPA has also issued the EIOPA *Preparatory Guidelines on Product Oversight and Governance Arrangements by Insurance Undertakings and Insurance Distributors*². These preparatory guidelines as well as the abovementioned EU Legislation were transposed in Chapter 2 of the Conduct of Business Rulebook.

The EBA *Guidelines on Product Oversight and Governance Arrangements for Retail Banking Products*³ set forth requirements for manufacturers and distributors when designing and bringing to market retail banking products and payment products and services (e.g. mortgages, personal loans, deposits, payment accounts, payment services and electronic money). The EBA published the first report *on the Application of the Guidelines on Product Oversight and Governance Arrangements*⁴ and recently released the second report⁵. These reports identify several good and bad practices and outline the next steps the EBA will take to fulfil its supervisory convergence mandate.

1.4 Methodology

The POG Cross Sectoral Thematic Review had the object of assessing the awareness and current status of application of the POG arrangements in the Maltese Regulated Financial Sector entities. It was divided into two main phases: [i] a self-assessment questionnaire; and [ii] onsite inspections.

¹ [ESMA 35-43-620, 2017](#)

² [EIOPA-BoS-16-071, 2016](#)

³ [EBA/GL/2015/18](#)

⁴ [EBA Report on application of POG, 2019](#)

⁵ [EBA Report on application of POG, 2020](#)

Phase I – The Self-Assessment Questionnaire

A self-assessment questionnaire was distributed to 98 licensed entities (i.e. investment firms, insurance undertakings and intermediaries, credit institutions and financial institutions). Entities in the process of surrendering their licence were excluded from the exercise. The POG self-assessment questionnaire included a quantitative and a qualitative part and was tailor-made with respect to the nature of the financial services sector in which the entities operated. Questions were designed in a generic manner to encompass the different business models and activities within the sample.

Entities had a period of six weeks (between 3 December 2019 and 10 January 2020) to provide their own assessment and make a high-level description of the POG arrangements in place.

In order to support entities in the completion of the self-assessment questionnaire, a glossary and a set of instructions were provided to clarify some of the terms and abbreviations used throughout the questionnaire.

The overall engagement of the entities was satisfactory. It was noted that cooperation was easier when the MFSA was dealing with contact persons employed by the specific entities rather than those from an outsourced function. In this respect, the MFSA would like to remind the industry that responsibility for the quality, comprehensiveness, responsiveness, and timeliness of the responses remains with the regulated entity.

With regard to the quality of responses, the MFSA noted more quality issues in the quantitative data provided. In general, entities had difficulties to provide complete and accurate data when requested. The Authority expects that regulated entities have in place adequate internal-external reporting capabilities to monitor their own compliance with regulatory requirements and to provide accurate information to the MFSA upon request.

Phase II - Onsite Inspections

Onsite inspections to a sample of 23 entities (i.e. investment firms, insurance undertakings and intermediaries, credit and financial institutions) were performed over a span of 10 weeks. Entities were chosen according to the size, complexity of business models, range and type of products offered (according to complexity) and type of service provided. Another criterion considered was the number of complaints received. The sample also included some firms offering services on a cross-border basis.

The MFSA informed the selected entities of the upcoming inspection by means of a pre-inspection letter and also requested certain documentation. The entities also received a work plan describing the list of stakeholders requested to attend meetings, the timeline of the interviews to be carried out and the meetings' agenda. In most of the cases, the interviews were carried out by multidisciplinary teams of MFSA officials to ensure that entities were

covered from a similar POG perspective. After completion of the field work, the Authority carried out limited follow-up meetings with certain regulated entities to discuss preliminary observations and request further clarifications when required.

Due to the COVID-19 situation, the business review exercises were not carried out as initially planned and communicated. Meetings and interviews were mainly conducted virtually, and initial timelines were adjusted. The MFSA appreciates the collaboration, flexibility, and preparedness of the entities to cooperate with the Authority during this challenging period.

Feedback Provided to Regulated Persons

In the context of investment firms and insurance undertakings and intermediaries, where the relevant requirements came into force in 2018, where POG arrangements were deemed to be manifestly lacking, these were required to update and implement these arrangements within a specified timeframe. With respect to credit and financial institutions, where the preparation of POG arrangements was still at an early stage, planned interviews were replaced by general discussions and supervisory expectations towards POG were explained.

Summary of Findings

In general, the MFSA found that most of the entities had made changes or are in the process of adjusting their internal arrangements to comply with the POG requirements. Changes were particularly noticeable from process systematisation and governance perspectives.

From the information obtained in the self-assessment questionnaires and subsequent onsite inspections carried out, it transpired that, in some cases, compliance with prudential requirements and commercial objectives prevailed over the interests of the clients. The Authority expects that POG policy in place (or under implementation) by entities ensure that the interests of clients are taken into consideration from the very beginning when the financial product is conceptually designed and manufactured and throughout the lifecycle of a product.

The level of awareness vis-à-vis POG arrangements varies across different sectors. In particular, more extensive supervisory work was carried out in the sectors relating to Insurance and Investment Firms. Furthermore, the size of the entities, the complexity of the governance structures (e.g. subsidiary of a foreign company) or even business agreements operated (e.g. agreements with card schemes), resulted in different levels of implementation of POG arrangements.

A significant number of entities did not clearly identify each stage of the product development process and did not document the specific steps followed at each stage (e.g. identification of the target market, testing and monitoring) in sufficient detail. The Authority expects that entities clearly identify product features, risks to clients, specificities of the target market, client needs and impact of product changes, as a minimum, in the product development process. The MFSA recognises the fact that implementation may be different

across entities and financial sectors according to the complexity and risk of the product. For instance, where the product is deemed risky to clients or especially complex, testing performed by entities should entail a larger set of scenarios and target market identification criteria should become more granular.

The thematic review showed that entities found difficulties in the identification of new or significantly changed products and services. This suggests that, across sectors, regulated entities may have different interpretations of the MFSA Conduct of Business Rulebook and European Guidelines.

Section 2: Good Practices Identified and MFSA Expectations

This part of the document is divided into two sections:

Section A refers to the POG good practices and expectations which apply to 'manufacturers'. Manufacturers are entities which are responsible for the development and issuance, or design of, a product or that make changes to, or combine existing products. Such entity may be:

- (i) any person authorised under the Insurance Business Act (Cap.403), or
- (ii) an investment services licence holder within the meaning of the Investment Services Act (Cap. 370); or
- (iii) any person licensed as a credit institution under the Banking Act (Cap. 371); or
- (iv) any person licensed as a financial institution under the Financial Institutions Act (Cap. 376)

Section B refers to the POG requirements which apply to 'distributors'. These are defined as being:

- (i) any person authorised under the Insurance Business Act (Cap. 403), the Insurance Distribution Act (Cap.487); or
- (ii) an investment services licence holder within the meaning of the Investment Services Act (Cap.370); or
- (iii) any person licensed as a credit institution under the Banking Act (Cap. 371); or
- (iv) any person licensed as a financial institution under the Financial Institutions Act (Cap. 376) that offers a financial instrument or product to clients by selling each product with or without advice.

The Authority's expectations, highlighted in this section, do not necessarily relate to specific findings of the onsite inspections or the questionnaire but are to be interpreted as the expectations of the Authority in the context of the various areas to which the POG requirements relate.

2.1 POG Good Practices and Expectations Which apply to Manufacturers

Internal Governance Arrangements

From the self-assessment and business review carried out it was observed that some entities had no POG arrangements in place or else are at an early stage in the development of those arrangements. For those entities which had POG arrangements and a Product Approval Process in place, it was noticed that those processes still need to be embedded in the culture of the entities. The MFSA considers that being compliant with POG regulations requires having a POG Policy or product approval process in place, however, this needs to be

sufficiently comprehensive and client-centric to ensure that the product under consideration offers positive outcomes for the client. In this context, the MFSA wishes to emphasise that the purpose of the POG process is to ensure that a product is designed and manufactured in a way which maximises positive outcomes for clients and eliminating client detriment as much as possible.

It was noted that some entities adopt a project management approach whenever launching a new product or service which enables entities to gather input from different stakeholders in the decision-making process, such as risk and compliance, and also consider any regulatory aspects, as well as the needs and interests of clients.

Manufacturers are expected to establish systems and controls to implement the POG policy in the Company's governance structure. In the written and documented POG Policy, manufacturers are inter alia expected to define and formalise:

- the roles and responsibilities of the different functions and relevant persons involved in the different stages of product design, development, approval, monitoring and review, as well as the interaction between the different departments within the Company;
- clear and adequate reporting-lines, escalation procedures and decision-making;
- the adequate involvement of Senior Management, Compliance in conjunction with functions, where applicable, particularly in the product approval process;
- how it adopts a client-centric approach, that is, the manner in which it ensures that client perspectives are taken into account in the different stages of the POG Process; and that its products generate good and consistent client outcomes and are aligned with the needs, objectives and characteristics of its identified target market;
- the manner in which it ensures that potential conflicts of interests between clients' interests and those of the manufacturer are identified and addressed.

Some entities do not have a dedicated internal body or committee responsible for the oversight of the product design phase and product approval before market launch. Some entities created working groups under the responsibility of existing committees or extended responsibilities of existing committees for the design, approval and review of new products. The MFSA does not prescribe any preferred corporate governance framework, however, considers it good practice to have defined structures and clear escalation and delegation lines of responsibility with respect to the product oversight and product approval processes. In this context, it is to be noted that the ultimate responsibility for the entity's POG policies and adherence thereto rests with the entity's Board of Directors.

It was noted that for many of the entities reviewed, the ultimate responsibility for the oversight of POG arrangements rests with the Board of Directors. In small or less complex entities the entire process tends to be directly managed by the management body which is deemed a good practice.

It should also be observed that the role of the Compliance Officer in the context of the POG obligations of the Regulated Person is to determine when a product approval process is required; if so, to ensure that it is correctly implemented, and to ensure that the necessary product monitoring and review is being carried out in line with the Regulated Person's POG policy.

The Compliance Officer is expected to check that the POG policies themselves are also regularly reviewed. In the context of Investment Firms, the Compliance function is assigned new and specific responsibilities in relation to MiFID II product governance requirements under Article 9(6) and (7) and Article 10(6) and (8) of the MiFID II Implementing Directive. These responsibilities have been enhanced by the new requirements which were introduced in *ESMA Guidelines on certain aspects of the MiFID II Compliance function*. With the new ESMA Guidelines requirements, the Compliance function is expected to ensure that it is in a position to report to the Board of Directors on the Company's product governance arrangements by taking into consideration, as a minimum:

- (i) the number and nature of the products manufactured or distributed by the Company, including information on their respective target markets and other information from the respective product approval process necessary to assess the product's compliance risk;
- (ii) whether the products are distributed outside their (positive) target market and to which extent.

In order to report on such matters, the Compliance function is expected to assess and evaluate any work, reports or methods adopted by the Company's function or personnel working on product governance arrangements. Moreover, the Compliance function is expected to report on the findings relating to the Company's product governance policies and procedures, breaches and deficiencies, actions taken or proposed to be taken to remedy breaches.

The Authority expects the Compliance function to act as a central point of reference for the Company's product governance processes and integrate product governance requirements in compliance reports.

The function responsible for deciding whether a product or service is new or significantly changed varies between entities. For small entities, ownership and responsibility for the product are both at management body level. For larger entities, ownership and responsibility may be at different hierarchical levels within the organisation but ultimate responsibility should be retained by the Board of Directors.

In some cases, the Risk or Compliance was indicated as being the main responsible function for the POG process. As stated above, the ultimate responsibility for the approval, implementation, monitoring, subsequent review and continued internal compliance with the over-arching POG policy rests with the Board of Directors.

The MFSA expects that in entities where an Internal Audit function is established, the POG process is actively considered when drafting audit plans for the respective entity. In addition to the main risks each entity is exposed to, such audits should also assess the extent to which regulatory requirements related to POG are properly followed and implemented. In this context, the Authority considers that the independence of the Internal Audit function needs to be maintained.

Some entities have in place or are designing specific workflow documents, internal checklists or assessment forms that need to be followed by different stakeholders to ensure that the process is harmonised for all products and services. Usually, these workflows are complemented with an escalation/delegation matrix of responsibilities according to the level of risk of the product or service. These workflows ensure there is an audit trail of decisions and the involvement of different stakeholders. The MFSA considers this a good practice, especially in large institutions.

As part of the manufacturer's POG process, the MFSA considers as a good practice the appointment of a person from within the entity to take the client's role throughout the product approval process. Such person will observe the client's interest in this process and should flag any decisions which could potentially lead to a negative outcome for the client in the context of the product being designed or modified.

From the onsite inspections it transpired that at times policies within entities are not consistently applied or sufficiently embedded within the entities. Decisions on new products or services were not always easy to trace.

The MFSA expects that the entities establish, maintain, and regularly update adequate written internal control policies, mechanisms and procedures. The system of documentation management in place should keep records of decisions taken (e.g. meeting minutes, agendas, proposals for discussion, decisions, follow-up actions) and ensure they are easily traceable and available for internal auditors, external auditors and the MFSA upon request.

The number of products or services identified as new or, in the case of insurance undertakings and credit and financial institutions, significantly changed, falling in the scope of POG requirements is materially different between entities in the scope of the Thematic Review. When it comes to the definition of the product or service it was not always clear for the entities what would be a new product or a significant change, where this is applicable, to an existent product. The criteria used to define what would constitute a new, or significantly changed product were non-existent in many entities or varied significantly among entities which had these in place.

The criteria used by entities to identify a new or, in the case of insurance undertakings and credit and financial institutions, significantly changed product or service tends to focus on:

- (i) prudential impacts, such as the impact on the credit, liquidity and/or operational risk of the entity;
- (ii) new processes and IT changes; and
- (iii) impacts on commercial arrangements.

The Authority is of the view that POG arrangements should also consider the impact on the needs, interests and characteristics of clients. To assess if a change is 'significant', where this is applicable, it is recommended that the potential impact of changes to the product on the target market are evaluated.

The different granularity of the criteria used may explain the discrepancy found in terms of the number of products or services ultimately identified as new or significantly changed. In the context of insurance undertakings and credit and financial institutions these are bound by POG requirements when carrying out respect to significant adaptations to their existing products. In this regard, with respect to insurance undertakings, the European Commission has provided the following guidance on what would constitute a significant adaptation of an insurance product⁵:

An adaptation of an existing insurance product may concern essential features of the product, such as:

- the risk coverage,
- the price and costs of the insurance product,
- the risks resulting from the underlying investments of an insurance-based investment product,
- a change to the target market identified by the insurance manufacturer, and
- possible compensation and guarantee rights for the benefit of the clients.

Whether the adaptation is "significant" has to be primarily assessed from the perspective of the average client. An important criterion consists in the question of whether the adaptation of the insurance product changes the compatibility of the product with regard to the target market and requires an adaptation of the target market. For example, the adaptation of the price and cost structure to inflation may be considered insignificant, whereas a price/cost increase which substantially impacts the return of an insurance-based investment product should be considered significant as this increase changes the return expectations of the insurance-based investment product.

With respect to Credit Institutions and Financial Institutions, manufacturers may consider whether a product is new or significantly changed by following the below list from the second EBA report on the application of the POG guidelines arrangements. The following list is by no means exclusive and is intended for guidance purposes only:

- significant changes in the processing of the product including an extension of the product distribution, the introduction of new, or the withdrawal of existing, product or service features;
- a change in the target market and the introduction of a new customer market segment (including geographically) as a target market;
- changes that affect the use of the product by the customer on a day-to-day basis;

⁵ See reply to Question 2266 of EIOPA's Q&As on Product and Oversight Requirements, as provided by the EU Commission: https://www.eiopa.europa.eu/content/2266_en.

- changes for which the customer would reasonably perceive there to be a change in the level of service compared with what is currently being provided;
- changes in one or more material features that alter the risk profile or the complexity of the product from a consumer perspective. Those changes should not only consider the risk profile in relation to the effect on FIs business or risk assessment portfolio, but also include changes that affect the use of the product by the customer on a day-to-day basis, changes for which the customer would reasonably perceive there to have been a change in the level of service compared with what is currently being provided;
- a change in the sale conditions, a new distribution channel or the introduction of an alternative channel of selling, including the use of third parties for the sale of the product;
- significant modifications to the product pursuant to new legal or regulatory rules and standards;
- material changes to related processes (e.g. new outsourcing arrangements) and systems (e.g. IT change processes), as defined in Guideline 18 of the separate EBA Guidelines on internal governance under Directive 2013/36/EU (EBA/GL/2017/11)18, but only if such changes have an impact on customers

During the course of this thematic review, the MFSA noted practices used by firms in order to identify products that significantly changed. These included instances where:

- (i) product changes are required due to the introduction of an alternative selling channel;
- (ii) product or service features that are materially changed;
- (iii) a changed target market (e.g. new client segment or new geographical location are included);
- (iv) when the daily usage of a product or service by the client has changed (e.g. online banking app); and
- (v) material change in the services supporting a specific product or service (e.g. new outsourcing arrangements, IT systems migration).

A few entities define significant changes by identifying and excluding changes that can be considered non-significant. However, for this purpose a threshold needs to be established by the entity itself, according to objective criteria. The MFSA sees merits in this practice, as it provides more objectivity in the product approval process, and the entities' decisions are easily justifiable and tracked.

In the context of insurance undertakings and intermediaries, where the insurance undertaking does not act as the sole manufacturer, the insurance undertaking is to engage with and enter into a written agreement with the other Co-manufacturer/s (an insurance intermediary or insurance undertaking) which may have a decision-making role in the design and development of the relevant product/s.

However, it is to be noted that an insurance undertaking which acts as risk carrier always qualifies as a manufacturer. In this respect, the insurance undertaking providing the coverage:

- should always be considered a co-manufacturer for the purposes of the application of POG requirements, its role, and contractual responsibilities with regard to the client and its role in the approval process of the insurance product; and
- remains fully responsible to the client for the contractual obligations resulting from the insurance product.

Target Market

From a manufacturers' perspective, the Authority observed that, in the main, manufacturers do identify the target market for a new or significantly changed product or service. The way this is done varies across entities and sectors. Many entities prefer to define broadly the target market particularly if products are deemed simple. The MFSA expects that the steps to identify a target market are not the same for all products and services and differ on a case-by-case basis depending on the risk and on the degree of complexity and nature of the product.

In general, with respect to the criteria used to identify the target market the answer varied from a simple answer: "*the client needs just a debit/credit card or a bank account or is a Maltese resident*" to a comprehensive list of criteria including geography, occupation, sector, age, risk profile or other key attributes of the target market. Financial capability (where applicable), geography or age are the most common criteria used by entities.

The Authority expects that the establishment of the target market should be meaningful. It would not be acceptable to describe the target market simply as a 'mass market' or solely by the categorisation of client (such as retail, professional and eligible counterparty) in the case of investments services. The POG policy needs to contain a clear, adequate and thorough process which specifies who has the role of defining the target market and the concrete steps to be followed for the proper identification and definition of the target market. This needs to include:

- a list of minimum criteria to be taken into account for defining the target market;
- the manner in which it will establish the target market at a sufficient level of granularity on a proportionate basis depending on the complexity and nature of the product and the risk of client detriment. This includes the manufacturer's approach to product classification according to risk and complexity, as necessary;
- in which cases it will consider identifying market segments for which the product is not considered appropriate (where relevant from a client protection perspective, in particular, for insurance-based investment products);
- how it will adequately demonstrate, per product, which criteria/factors have taken into account in identifying the target market, as well as the relevant choices made based on the relevant product metrics and information collected (to ensure that

a particular product is compatible with the needs, objectives and characteristics of the product); and

- how the design of a product/proposed change is driven by features that benefit the client; and not only from a commercial viability/profitable viewpoint.

Some entities perform client research systematically to verify whether products or services meet the interests, objectives and characteristics of the target market. Except for a few entities that seem to research client needs and design products in line with that outcome, most research tends to focus on commercial aspects (i.e. if there is a market for the product to be sold). The MFSA recommends that priority is given to client research with the objective of ensuring that the products are meeting the client needs.

In applying the principle of proportionality referred to above, the manufacturer should consider the complexity of the product in question. In this regard, each manufacturer is expected to identify "complex" or "non-complex" products and to keep records of the criteria used in this assessment. In assessing the notion of complexity, manufacturers should consider the client's perspective, in particular the latter's ability to understand the features of the financial product in question.

Testing

The manufacturer is expected to outline in sufficient detail, within its POG Policy, the concrete steps and the approach adopted to conduct appropriate product testing, with the primary aim of ensuring that the product, over its lifetime, meets the identified needs, objectives and characteristics of the clients belonging to the identified target market. Such testing shall be conducted in all of the following instances:

- before bringing that product to the market; or
- before significant adaptations or changes of a product are introduced; or
- if the Identified Target Market has significantly changed.

In this respect, the manufacturer is expected to, at least, clearly define and document:

- who is involved in the product testing phase as well as the responsibility and accountability for such testing;
- the form and method of product testing utilised to test product attributes to ensure that it meets the needs and reasonable expectations of the identified target market;
- when scenario testing is considered relevant and when quantitative testing is also required;
- the manner in which product testing considers whether the product will deliver fair client outcomes; and
- all testing carried out, as well as the decisions and steps taken following the results of such, per product;

- how product testing has influenced the definition of the final identified target market, including records of whether following such testing the target market was revised.

The Authority expects that, as a minimum, the manufacturer:

- adopts a pro-active approach to testing, for instance, the manufacturer defines a priori certain quantitative thresholds to consider the product as compatible with the target market;
- considers Fairness testing and a "Value for Money Test" for clients, which may include:
 - (i) client testing: such as analysis of contracts and complaints for similar products; research surveys and internal/external focus groups to test the wording and the comprehensibility of the product documentation, the terms and conditions, and the interests of the client; and
 - (ii) assessments of the costs and pricing of the product to verify whether it offers good value to the clients purchasing the product;
- demonstrates that in the design, monitoring and review process, the manufacturer does not focus only on the profitability and feasibility of the product.

In general, the MFSA expects that entities have in place a testing framework commensurable to the nature and scale of the risk the client is exposed to, as well as to the ability of the entity to manage such risks. Focusing purely on commercial aspects to decide on testing is not deemed a good practice.

The MFSA encourages the use of client research and pilot or targeted releases to evaluate how products may affect the target market. This can also prove to be an efficient way of assessing the clients' understanding of product features or the need to set product variations to accommodate segments of the target market.

Testing the effectiveness of the internal and external communication channels to reach the desired segments of the target market is also seen as positive practice.

The MFSA considers testing against the negative criteria such as clients that fall outside the target market's definition in terms of age, sector, occupation, financial capability or geography is also important.

The MFSA understands that testing can follow a proportionate approach according to the complexity and risk of the product. For instance, testing can mainly focus on client knowledge, understanding of the product and communication when the product is simple or has a broad target market. However, for more complex and riskier products such as credit products, derivatives, CFDs or unit-linked products it is expected that testing should be more comprehensive and should include different scenarios to ensure entities have a clear

perspective of how the product target market may be affected (e.g. different interest rates scenarios, different volatility scenarios or different underlying price scenarios).

The MFSA expects that when scenario testing is used, this is properly documented and explained. Those scenarios should be made available as supporting information for the product decision making process. In particular, it is expected that such testing would involve the assessment of how a product will behave when its underlying assumptions are changed. This can be done by using computer models which allow for simulations to be performed.

For some entities (e.g. financial institutions) the operational testing of the product is deemed critical and leads to changes that most of the time is not visible to the client but could still affect the client from a product security perspective (e.g. enhancement of security measures to prevent fraud in debit and credit cards, dealing with cybersecurity issues on mobile banking apps, etc).

A few entities found it beneficial to seek views from clients during the design phase of the product, for instance through client working groups, surveys, or face-to-face meetings. Other entities created dedicated structures to develop client intelligence and set adequate product pricing. The Authority considers such measures as good practice.

Monitoring and Remedial Actions

Entities interpret the review of products from diverse perspectives. This led to a wide range of responses on the depth of the review and its frequency. Some entities stated that they review products on a weekly, monthly, or quarterly basis, whilst others review products on a yearly basis or every three years.

Although monitoring products from a commercial or profitability perspective is done regularly by most of the entities, the MFSA is of the view that this is a limited review of the product. The Authority expects that review of the products should consider *inter alia* an analysis on whether the product meets the clients' needs and interests. The frequency of such review should be linked to the risk and complexity of the product.

A few entities are developing a process to track the dates when product monitoring reviews are due. This is particularly relevant for entities with several products as it ensures that updates due to the relevant decision bodies are provided timely. The MFSA considers this a good practice as it ensures that ongoing product monitoring is structured, transparent and that there is ownership and accountability.

Some entities use management dashboards with specific Key Risk Indicators or Key Performance Indicators to monitor their activities, however the majority only use commercial and profitability metrics. The MFSA would expect that further to the commercial information other information to assess client needs and risks could be included in those dashboards to improve product monitoring.

A few manufacturers perform or demonstrated the intention to perform a specific post-implementation review. This review would take place in a short timeframe after the launch

of the product (e.g. six-12 months), where a number of criteria that justified the launch of the product would be reassessed. The MFSA considers post-launch reviews as a good practice. These may be more relevant especially for products that are deemed more complex or risky for clients. The Authority considers it also a good practice defining (in the internal policies such as the Product Approval Policy) the circumstances and product changes that may trigger *ad hoc* reviews.

Entities performing product reviews did not provide many details on the tools used or criteria assessed. For the institutions reviewed, commercial aspects were the most relevant trigger for a product review. A few mentioned that the outcome of client surveys, client satisfaction indicators, the number of complaints, suggestions and feedback received on products either by clients or staff were taken into consideration for a product review. The MFSA expects that client-centric metrics are part of the tools used by entities to monitor and review a product or service.

In terms of the applicable regulatory requirements, the manufacturer is required to establish adequate frameworks and strategies for the conduct of continuous monitoring and regular review of its products and distributors. In this respect, the manufacturer needs, for example, to ensure that it:

- utilises specific tools to undertake a comprehensive assessment of specific criteria for the purposes of continuously monitoring its products be alert to “crucial events” that would substantially affect the product. These criteria would include:
 - (i) events that could materially affect the main features of the product such as the risk coverage, where applicable, or the guarantees of those products, if any;
 - (ii) the alignment of the product with the needs, characteristics and objectives of the identified target market;
 - (iii) whether products continue to deliver fair client outcomes, which includes checking whether products are sold to clients belonging to the relevant Target Market or whether it is reaching clients outside the Target Market, and if so, the reasons behind such deviations;
- determines how products are regularly reviewed upon appropriate intervals established by the manufacturer on a per product basis. Such review is to be based on pre-set criteria which need to include factors to verify that products are performing as expected during the whole product lifecycle, from a client perspective. This includes checking if the product performance actually or potentially leads to client detriment, as well as identify any event which could materially affect the potential risks to the identified target market;
- establishes a process for *ad hoc* trigger-based product reviews based on pre-identified indicators/events that would lead to such reviews (including as a result of findings from the monitoring);

- monitors conduct risks and ensures appropriate mitigation measures are taken. The manufacturer is also expected to adequately demonstrate how product monitoring and reviews are carried out, by sufficiently looking at product performance from a client perspective and to set out the tools utilised to assess client outcomes.

It is expected that manufacturers look at product performance from a client perspective. Examples of elements (where applicable) that manufacturers are highly recommended to look at when assessing client outcomes vis-à-vis their products include:

- Cost-efficiency which should include whether the product is cost-efficient for clients;
- Usefulness of the product which should include if it still brings added value to the target market;
- Safety which should include if the product is still safe for the target market, taking into account its objectives, needs and characteristics and market conditions, or whether it leads to increased risk of client detriment;
- Comprehensibility which should include whether the product and its features (e.g. terms and conditions and fee structure) are not unnecessarily complicated for, but can be fully understood by the target market, and thereby permit informed choice; and
- Whether the target market is (still) adequately defined.

The manufacturer is also expected to assess sources of client detriment and take remedial action, as necessary. In this respect, a manufacturer shall exert its best efforts to, as a minimum:

- provide distributors with the necessary information on the target markets to enable the distribution of the product in accordance with the best interests of the client; and
- monitor on an ongoing basis that the product continues to be aligned with the interests, objectives and characteristics of the target market and also, to take any remedial action to mitigate any circumstances related to such product which the manufacturer identifies as giving rise to the risk of client detriment.
- keep a good audit trail of decisions taken related to product monitoring and review. It should also take follow-up actions on complaints received, expectations of clients expressed during interaction with the manufacturer (e.g. during claims handling processes), monitoring reports, number of sales outside the target market and minutes of POG-related meetings.

Indicators of client detriment may be identified from the findings of the product monitoring exercise, the regular product review, through complaints, and information provided by its distributor/s. In this respect, where the manufacturer is an insurance undertaking or credit

institution or financial institution, it is expected to take appropriate remedial action to avoid any further client detriment and:

- (i) have a clear process in place to identify the kind of follow-up actions to be undertaken following such outcomes with the aim of mitigating product-related risks that may adversely affect clients and prevent further occurrences of the detrimental event. In this respect, the manufacturer is expected to decide what steps it needs to take, based on the circumstances of the case, which may include, changing the product and its characteristics to minimise detriment; changing the target market; or stopping further issuance of the product;
- (ii) have documentation in place that evidences the reasons behind decisions or actions taken in all stages of the Product Distribution Process. It is also recommended that a central log is kept by the manufacturer in this respect.

Distribution and Information Exchange with Distributors

Manufacturers are required to select distribution channels that are appropriate for the defined target market and for the product's characteristics. In this regard, the manufacturers' over-arching POG policy should contain appropriate processes and controls that determine the processes, criteria and steps to be followed for the development of distribution strategies.

Manufacturers are also required to monitor whether products are sold within the target market and whether conflicts of interests are adequately managed and whether, for specific distribution channels (e.g. distance and/or online selling), they have put in place adequate controls.

Some entities seemed to interpret the scope of the term 'distributor' and the supervisory expectations thereof in a very narrow manner (e.g. entities that distribute their own products). The MFSA considers that this understanding is not in line with its Conduct of Business Rulebook or the European Guidelines. Manufacturers continue to have obligations towards distributors irrespective if the distribution takes place in-house or not. The POG regulations are also applicable to the entities' front office and sales staff. For entities that distribute their own products it is expected that, at least, internal arrangements are in place to ensure information flow between the manufacturing and the distributing function, adequate training and supporting material is provided and client needs, interests and satisfaction are captured and reflected in future product reviews.

With respect to distribution arrangements and regulation of responsibilities between manufacturer and distributor the outcome was mixed. The MFSA expects that a distribution agreement regulating the manufacturer and third-party distributors' responsibilities during the product development and marketing processes is in place. Moreover, linking the remuneration of distributors to client satisfaction and compliance with the applicable regulatory requirements is seen as a good practice.

In line with the POG regulations, it was noted that manufacturers provide specific materials to distributors, including marketing materials, FAQs, key information documents, prospectus, brochures providing information on the product, its target market and risks associated. The MFSA expects that this information is complemented with training material and when needed, distributors should receive physical and online training.

2.2 POG Good Practices and Expectations Which Apply to Distributors

This section contains MFSA's expectations with respect to entities which merely distribute products manufactured by third parties. In terms of the POG requirements, distributors are required to have in place Product Distribution Arrangements which serve to ensure, *inter alia*, they only sell products to clients which fall within the target market established by the manufacturer for that particular product.

Product Distribution Process and Procedures

Distributors are required to establish and implement a clearly structured and appropriate Product Distribution Process reflecting their distribution activities, in practice. In this respect, distributors are expected to establish the concrete and necessary steps and describe adequate measures and controls in their Policy and Procedures which include, at least:

- clear reporting lines, escalation procedures and decision-making, as well as clearly formalised and defined division of tasks and responsibilities for the various stages of the Product Distribution Process (including the selection of products for distribution, own distribution strategy for specific products, the monitoring of product distribution, and flow of information with manufacturers);
- procedures to ensure that staff distributing products continuously comply with the Product Distribution process in their everyday activities. It is expected that precise and traceable documentation of processes in manuals, handbooks or other forms of instructions is made accessible to all relevant staff and that relevant training is provided thereto;
- methods applied to ensure that in the course of the product distribution process it matches the interests and objectives of its client base with those of clients belonging to the target market of the product as established by the manufacturer;
- procedures to manage conflicts of interests and identify and report any circumstances that may adversely affect clients;
- the manner in which it will monitor that products are sold to identified target market and measures taken in instances in which product is sold outside the target market;

- the adoption of a client-centric approach to its Product Distribution Process to ensure that the products it distributes generate good client outcomes and are aligned to the identified target market;
- the proper documentation of all relevant actions taken by a distributor in the product distribution process, as well as any action taken to prevent and mitigate client detriment. It is also recommended that a central log is kept in this respect.

It was noted that in some cases the target market assessments did not include information of the method of distribution. Consequently, a distinction is not made as to whether the same product can be offered via more than one distribution channel.

Distributors must determine which products are going to be recommended or actively marketed to certain groups of clients (characterised by common features in terms of knowledge, experience, financial situation, etc). In the context of investment firms distributors should also decide which products will be made available to clients at their own initiative through non-advisory services without active marketing, considering that in such situations the level of client information available may be very limited. Distributors shall, on a regular basis, assess whether the intended distribution strategy remains appropriate.

Target Market

Distributors must use the same list of criteria used by manufacturers as a basis for defining the target market for their products. Nevertheless, distributors are expected to define the target market on a more concrete level than the manufacturer and should take into account the type of clients they provide services to, the nature of the products and the type of the services they provide. In the context of investment firms, distributors are expected to clearly specify in their target market assessments the type of investment service through which the relevant product or asset class is eventually provided to the end client. In this manner, the Company's client-facing staff are expected to be guided on the manner in which the financial product in question is offered to the client.

It was observed that some investment firms use generic and undefined terms such as 'low/conservative', 'medium/moderate/balanced' or 'high/elevated/aggressive' to describe the risk appetite of the client. Such terms are subjective and subject to different interpretations by each investment advisor. Moreover, it was noted that some investment firms indicated in their target market assessment that for the Knowledge and Experience criteria clients must have all knowledge and experience in respect to all the investment products which are distributed by them. The target market definition should specify the knowledge and experience that the target clients should have about the financial instrument including the product type, product features and thematically related areas that help understand the product in question.

In the case of investment firms which act as distributors and of distributors of insurance-based investment products, these are expected to specify the general attitude that target clients should have in relation to the risks of the investment/insurance-based investment product. Therefore, basic risk attitudes should be categorised and clearly described. Since

different Regulated Persons may have different approaches to defining risk, distributors should be explicit about the criteria that must be met in order to categorise a client within the permitted ranges (basic/low/conservative; moderate/medium; elevated/high/long term).

It was noted that some of the investment firms only conduct target market assessments for UCITS funds and ETFs. Investment firms are required to comply with the requirements of the Rules when offering or recommending financial instruments (such as bonds and shares) manufactured by entities that are not subject to the Rules. As part of this process, firms shall have effective arrangements to ensure that they obtain sufficient information about these financial instruments from these manufacturers. Firms are therefore obliged to determine the target market for the respective financial instruments, even if the target market was not defined by the manufacturer.

Necessary Information from Manufacturers

The distributor is to take a proactive approach in its Product Distribution Process. It should establish, in a clear and sufficiently detailed manner, the measures, controls and tools utilised to regularly obtain from manufacturers all appropriate and necessary product information to carry out its distribution activities, taking into account the complexity and risks of the product. This is to include information to enable the distributor to understand:

- the main characteristics of each product, its risks and costs, as well as circumstances which may cause a conflict of interests at the detriment of the client;
- the product approval process (of the manufacturer), including the identified target market and the suggested distribution strategy of the product;
- the characteristics and identified target market of each product, identified by the manufacturer.

Information and Support to the Manufacturer

In order to enhance the exchange of information with the manufacturer, the distributor needs to determine the appropriate intervals to regularly inform the manufacturer about product findings and performance. In this respect it is also expected to establish, in a clear and sufficiently detailed manner, adequate systems and controls to conduct the necessary verifications, as well as to identify and report to the manufacturer, at least, in relation to the following:

- information about the distributor's monitoring of the products' performance and client outcomes and that required by the manufacturer for its product-review, which may include sales information, summary information on clients and summary of the complaints received, with regard to a specific product;
- any product-related circumstances that may adversely affect the clients;

- verify that products are distributed in line with the needs, objectives and characteristics of the target market identified by the manufacturer; and determine for specific products instances where sales outside of the target market are made and justified;
- processes to take appropriate action to avert the risk of client detriment or situations where the product is not aligned with interests, objectives and characteristics of identified target market.

Distributors are to ensure that any information that is needed by the manufacturers in order to complete their review is readily available and can be provided without delay. The above-referred information may be in an aggregated form and does not need to be on an instrument-by-instrument or sales-by-sales basis.

Co-Manufacturing of Products

Where relevant, an overall analysis of the specific activities of the distributor is to be carried out on a case-by-case basis. Such an assessment is to be documented and an analysis should be made as to whether the distributor is acting as a *de facto* manufacturer, that is whether its activities show that it has a decision-making role in designing and developing the product for the market.

Wherefrom such an assessment it results that for particular product/s the intermediary acts as a *de facto* manufacturer, it needs to enter into a signed written agreement with the undertaking which specifies, amongst other matters:

- their collaboration to comply with the requirements applicable for manufacturers;
- their respective roles in the Product Approval Process;
- procedures through which they shall agree on the identification of the Target Market.

Observations and Expectations on Product Governance and Oversight Arrangements with respect to Online Forex Brokers and CFD Investment Firms

It was noted that half of the population of the Online Forex Brokers and CFD investment firms inspected did not have Product Distribution Arrangements in place. It was observed that the remaining population has put policies and procedures relating to product oversight and governance in place. However, these were very high level and did not provide adequate information on the arrangements these firms have in place. Moreover, such policies and procedures do not reflect the entities' assessment from a product governance angle, which apply insofar as products and services that they offer to clients.

It is expected that Regulated Persons set out their product governance and oversight arrangements in writing and include in its policy and procedures the actual arrangements and processes (for instance, the identification of the target market) which it undergoes from

a product governance perspective. The product governance and oversight arrangements should also include the proper management of conflicts of interest.

The population of online forex firms inspected failed to provide a satisfactory definition of their target market or to explain how they align the needs of this group of clients to the product they offered. On the contrary, clients were being assessed at on-boarding stage through an appropriateness assessment, that is, on an ex post basis.

Given the inherent risk of CFDs, it is important that Investment Firms abide by the MiFID II product governance requirements. CFDs are high-risk, complex financial products. Furthermore, CFDs are typically used for speculative trading purposes and are often highly leveraged. The referred features put individuals at risk of losing significantly more than their original investment. For this reason, the actual target market has to be identified precisely and 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 (the 'negative target market'). This will enable such entities to understand and evaluate how appropriate the product is and also assess whether it is meeting their clients' needs on an ongoing basis. Firms need to be able to adequately explain how the nature and risks of the CFD product is aligned to their target market.

Categorising clients as 'retail', 'professional' and 'eligible counterparty' is not enough to identify the actual target market. Furthermore, particular care should be given when firms categorise clients as 'elective professional'. Firms should not rely on their clients' own opinion of their knowledge and experience, as this is highly subjective and is unlikely to be reliable, at least on its own. Firms should request facts and information evidence their assessment of a prospective client's expertise, knowledge and experience in ways that gives them reasonable assurance, given the nature of the planned transactions or services, that the client is capable of making their own investment decisions and understands the risks involved.

Firms should not rely on broad investor descriptions such as 'experienced', 'sophisticated' and 'financially literate', without having a clear definition of what these terms mean in practice. Such broad definitions of target markets may lead firms to conclude that CFDs are appropriate for most potential clients, which is unlikely to be the case given the high-risk and complexity of such products. Additionally, if manufacturers share a poorly defined target market definition with their distributors to help their decision-making, then these intermediaries may also reach the same incorrect conclusions about the appropriateness of such products for the end clients.

Sales to investors which fall within the negative target market should be a rare occurrence and 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. Furthermore, the sales of products to clients not within the target market, and that could potentially be unsuitable should always be reported to the manufacturer and disclosed to the client.

Firms are reminded that the requirement of identifying the actual target market is not substituted by an assessment of appropriateness, and therefore the referred target market assessment has to be conducted in addition to and before such an assessment.

Way Forward and Next Steps

The Authority is currently engaging on a bilateral basis with the entities at which it has conducted an onsite inspection in the context of this cross-sectorial thematic review.

All regulated entities, including those which have not been subjected to an onsite inspection are expected to come in line with the Authority's recommendations and expectations as outlined in this document. The Authority may in the future carry out further supervisory work in this area not least to ensure compliance with the abovementioned requirements and expectations.

The supervisory expectations contained in this document are without prejudice to any other expectations which may be published by the ESAs in the context of Product Oversight and Governance requirements in due course.

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