

# Final report

Guidelines on MiFID II product governance requirements



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# 1 Executive Summary

## Reasons for publication

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

This Final Report builds on the text of the 2017 ESMA guidelines<sup>1</sup>, which have been reviewed taking into account the following recent regulatory and supervisory developments: the European Commission’s Capital Markets Recovery Package and subsequent Amending Directive<sup>2</sup>; the sustainability-related amendments to the MiFID II Delegated Directive<sup>3</sup>; the recommendations on the product governance guidelines by ESMA’s Advisory Committee on Proportionality (ACP); and the findings of ESMA’s 2021 Common Supervisory Action on product governance<sup>4</sup>.

On 8 July 2022, in accordance with Article 16(2) of the ESMA Regulation, ESMA published a Consultation Paper (CP) with proposed draft guidelines on MiFID II product governance requirements. The consultation period closed on 7 October 2022. ESMA received a total of 67 responses, 10 of which confidential. ESMA also sought the advice of the Securities and Markets Stakeholders Group (SMSG). The responses received are available on ESMA’s website unless respondents requested otherwise. This paper summarises the responses to the CP and explains how the responses have been taken into account. ESMA recommends reading this report together with the CP to have a complete view of the rationale for the guidelines.

By pursuing the objective of ensuring a consistent and harmonised application of the product governance requirements, the guidelines will make sure that the objectives of MiFID II can be efficiently achieved. ESMA believes that the implementation of these guidelines will strengthen investor protection, which is a key objective for ESMA.

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<sup>1</sup> ESMA35-43-620

<sup>2</sup> Directive (EU) 2021/338 amending Directive 2014/65/EU

<sup>3</sup> Commission Delegated Directive (EU) 2021/1269 amending Delegated Directive (EU) 2017/593

<sup>4</sup> ESMA35-43-3137

## **Contents**

Section 2 gives an overview of the guidelines. Section 3 includes the Annexes: Annex I contains the cost-benefit analysis; Annex II summarises the opinion of the Securities and Markets Stakeholder Group (SMSG); Annex III contains the ACP Advice on Proportionality of the ESMA Product Governance guidelines; Annex IV provides the feedback statement; Annex V contains the full text of the final guidelines; Annex VI shows a list of good practices observed from the supervision of the MiFID II requirements on product governance and Annex VII outlines illustrative examples and case studies related to the application of certain aspects of the guidelines.

## **Next Steps**

The guidelines in Annex V will be translated in the official EU languages and published on ESMA's website. The publication of the translations in all official languages of the EU will trigger a two-month period during which NCAs must notify ESMA whether they comply or intend to comply with the guidelines.

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## 2 Background

### 2.1 Overview

#### *Background*

1. MiFID II<sup>5</sup> introduced product governance requirements for firms that manufacture and distribute financial instruments and structured deposits (“products”). These requirements have proven to be a key element of the MiFID II investor protection framework, requiring firms that manufacture or distribute products to act in clients’ best interests during all stages of the life cycle of products or services. In accordance with Articles 16(3) and 24(2) of MiFID II and Articles 9 and 10 of the MiFID II Delegated Directive<sup>6</sup>, firms that manufacture products for sale to clients or distribute products to clients shall maintain, operate and review adequate product governance arrangements. As part of these arrangements, a target market of end clients and a distribution strategy that is consistent with the identified target market shall be identified and periodically reviewed for each product.
2. In June 2017, ESMA published its guidelines on certain aspects of the MiFID II product governance requirements<sup>7</sup> (“guidelines”), mainly providing guidance on the target market assessment, as this aspect was considered as the most relevant one for ensuring a common, uniform and consistent application of the product governance requirements.
3. While the guidelines remain relevant, several recent regulatory and supervisory developments have prompted a review of the guidelines:
  - the Commission’s Capital Markets Recovery Package and subsequent MiFID II Amending Directive;<sup>8</sup>
  - the sustainability-related amendments to the MiFID II Delegated Directive;
  - the recommendations on the product governance guidelines by ESMA’s Advisory Committee on Proportionality (“ACP”); and
  - the findings of ESMA’s 2021 Common Supervisory Action (“CSA”) on product governance<sup>10</sup>.

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<sup>5</sup> Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014.

<sup>6</sup> Commission Delegated Directive (EU) 2017/593 of 7 April 2016.

<sup>7</sup> ESMA35-43-620.

<sup>8</sup> Apart from the proposed changes to MiFID II, the EC’s Capital Market Recovery Package also encompasses proposals of amendments to the Prospectus Regulation and the Securitisation Regulation, see also: [https://ec.europa.eu/info/publications/200722-proposal-capital-markets-recovery\\_en](https://ec.europa.eu/info/publications/200722-proposal-capital-markets-recovery_en)

<sup>9</sup> Commission Delegated Directive (EU) 2021/1269 amending Delegated Directive (EU) 2017/593

<sup>10</sup> ESMA35-43-3137

### *Public consultation*

4. On 8 July 2022, ESMA published a Consultation Paper (CP)<sup>11</sup> on the draft guidelines on MiFID II product governance requirements in order to explain its rationale and gather input from stakeholders. The consultation period closed on 7 October 2022.
5. ESMA received a total of 67 responses, 10 of which confidential. The answers received are available on ESMA's website unless respondents requested otherwise. ESMA also sought the advice of the Securities and Markets Stakeholder Group's (SMSG).

### *Final report*

6. This Final Report summarises and analyses the responses to the CP and explains how the responses, together with the SMSG advice, have been taken into account. ESMA recommends reading this report together with the CP to have a complete view of the rationale for the guidelines.

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<sup>11</sup> ESMA35-43-3114.

## 3 Annexes

### 3.1 Annex I - Cost-benefit analysis

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

#### **The impacts of the ESMA guidelines**

4. In light of the main objectives of the guidelines (extensively illustrated in the background section), the following assessment aims at explaining the benefits and costs of the key policy choices.
5. It should be preliminary observed that since product governance requirements are provided under MiFID II and the relevant Delegated Directive, the impact of the guidelines should be considered having in mind the legal provisions that they support. While market participants will likely incur certain costs for implementing these guidelines, they will also benefit from the increased legal certainty and the harmonised application of the requirements across Member States. Investors will in turn benefit from an improved compatibility between products and their needs, objectives and characteristics. The guidelines should also facilitate competent authorities' (NCAs) efforts to improve the overall compliance with MiFID II requirements increasing the investor confidence in the financial markets, which is considered necessary for the establishment of a genuine single capital market.
6. Finally, it is important to remind that the existing 2017 guidelines which are confirmed should not imply any additional impacts/costs for both firms and NCAs.

#### **Benefits**

7. It is possible to illustrate the main benefits linked to the guidelines as follows:
- reduction of the mis-selling risk and its related financial consequences. This is a major benefit for investors and for the financial markets as whole. In particular, firms will benefit from the reduction of complaints, litigation costs, fines, etc. and from a negative impact on reputation.
  - reduction of risks linked to regulatory or supervisory arbitrage due to an increased degree of harmonisation and more consistent supervisory convergence;
  - positive effects from improved harmonisation and standardisation of the processes that firms have to put in place when implementing the MiFID II product governance framework;
  - positive effects from improved harmonisation and standardisation for competent authorities on the costs and activities needed to implement the new supervisory processes related to product governance; and
  - reduced risk of greenwashing in the manufacturing and distribution of products.

### **Costs**

8. With reference to the costs, it should be reminded that the key aspects of the product governance requirements and of these guidelines have remained unchanged. Moreover, the amendments mostly concern clarifications rather than completely new approaches.
9. In light of what has been said, it can be reasonably expected that those firms already having in place a complete set of arrangements to comply with the existing MiFID II provisions will presumably incur fewer overall costs when implementing the updated framework and these guidelines.
10. ESMA considers that potential and incremental costs that firms will face, when implementing the overall product governance framework under the MiFID II regime (including but not limited to these guidelines), might have both a one-off and an ongoing nature, arguably linked to:
- (direct) costs linked to the update/review of the existing procedural and organisational arrangements (e.g., the review and/or the update of firm's arrangements to identify the target market for products, due to the specification of any sustainability-related objectives);
  - (direct) initial and ongoing IT costs; and
  - (direct) relevant organisational and HR costs linked to the implementation of the guidelines.

### **Conclusions**



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

### 3.2 Annex II - Advice of the Securities and Markets Stakeholder Group (SMSG)

1. As provided by Article 16(2) of the ESMA Regulation, ESMA also sought the advice of the SMSG.<sup>12</sup>
2. The SMSG made the following general remarks:

*“In general, the SMSG is of the opinion that the revised guidelines are balanced, fairly reflect and elaborate on the changes in Level 1 and Level 2 texts, and adequately deal with the results of the 2021 Common Supervisory Action on MiFID II Product Governance Requirements. The SMSG indeed highly appreciates the continuation between different ESMA work streams, in the sense that the draft guidelines are heavily informed by ESMA’s Common Supervisory Action.*

*The SMSG stresses the need for a proportional application of the product governance requirements. This is already reflected in certain specific guidelines, such as paragraph 27, which requires that in ensuring that homogenous clusters are identified, firms should pay particular attention to the level of complexity of products.*

*The SMSG stresses the need for consistency in terminology and processes (i) between the product governance guidelines and industry standards (such as the European MiFID Template and the Association concept) that are generally used in the market; (ii) between manufacturers and distributors; (iii) between the product governance guidelines on the one hand and the suitability and appropriateness guidelines on the other hand; and (iv) between the product governance guidelines and the PRIIPs framework (where relevant). ESMA should ensure consistency in and between its own guidelines, as well as between the terminology and processes of the PRIIPs framework and the product governance framework, so as to avoid confusion and duplication of work. Moreover, ESMA could stimulate industry associations to further develop market standards in the light of the revised product governance, suitability and appropriateness guidelines.*

*In this regard, the SMSG remarks that the draft guidelines deviate on several occasions from the terminology used in the European MiFID Template (EMT) and the association concept, which have become industry standards. The SMSG strongly advises ESMA to align the wording of the guidelines with these industry standards, unless ESMA has good reasons to use a different wording. The SMSG has debated on the question whether ESMA should go beyond that and endorse the industry standards. The SMSG does not think that ESMA should do so. It should, however, in the guidelines clearly refer to current industry standards, and clarify that it aligns the wording of the guidelines with the industry standards as much as possible.*

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<sup>12</sup> The SMSG’s response has been published on the ESMA website (Ref: ESMA22-106-4247).

*In view of the close connection between product governance and suitability, the two sets of guidelines should be optimally aligned. Therefore, the SMSG is of the opinion that the two sets of guidelines should be finalised and come into effect at the same moment.*

*The SMSG agrees that the target market should be sufficiently granular, but not overly granular. If target markets are defined in too much detail this may lead to “closed shops”, where only distributors from the same group as the manufacturer are able to fully comprehend the scope and meaning of overly granularly formulated target markets. Requiring too much granularity may put the continued existence of an open architecture at risk, which would be detrimental for investors. Moreover, overly complex requirements would favour the largest players. Therefore, a balance needs to be struck also between granularity of target market requirements and practicability in terms of compliance.*

*For instance, the case study at p. 50 of the draft guidelines mentions under “clients’ knowledge and experience” “experience with direct investment in structured products”; the case study at p. 51 mentions under “clients’ knowledge and experience”, “some knowledge or experience of the share index and the index mechanics”. However, with this level of detail of target market descriptions, the “knowledge and experience” section would include at least 10 to 15 categories. In integrated financial groups, a distributor will easily implement such target market descriptions; for independent distributors this will be much harder to match with information gathered from clients in the context of suitability and appropriateness assessments that are not aligned with such overly detailed target market descriptions. In the same vein, the “know your distributor”-requirements for product manufacturers should not be overly demanding, since this could negatively affect the development of open architecture models and hamper the offering of independent advice.*

*Moreover, for an efficient feedback loop to be installed between product distributor and product manufacturer, categories which are less granular would need to be introduced. The SMSG is of the opinion that there is a trade-off between on the one hand the granularity and relevance of the information in the target market, and on the other hand the feasibility of an efficient feedback loop.*

*A closely connected, but different issue, is that the product governance requirements should not overly restrict access of investors to higher risk products or to products requiring higher knowledge and experience, provided the appropriate investor categories are duly targeted for the appropriate products.*

*The SMSG has a methodological comment in respect of the establishment of “good” and “bad” practices in the guidelines. While the SMSG is of the opinion that, in general they may be of help in clarifying the meaning of the regulatory framework, it strongly advises ESMA to clarify what is the legal effect of mentioning a certain practice as a “good” or a “bad” practice. Are those examples meant to clarify the guidelines, or even*

*to nudge market participants to behave in a certain way (good practices)? Are the “bad” practices prohibited in all circumstances? Are they subject to sanctions?*

*Similarly, the SMSG wonders what is the legal effect of using case studies in the guidelines. For instance, the case studies use a certain vocabulary. Should market participants use the same, as a kind of template?*

*After the guidelines will have been finalised, the market will need time to adapt. ESMA should take this into account when determining when the guidelines will enter into force. The SMSG advises ESMA to urge the NCAs to take into account practical constraints of market participants in complying with these guidelines. A distinction should be made between what is theoretically possible and what is for the time possible from a practical point of view, for instance due to the lack of data.”*

3. The SMSG also had specific remarks on the guidelines that are summarised and addressed in the Feedback Statement section of this Final Report.

### **3.3 Annex III - ACP Advice on Proportionality of the ESMA Product Governance Guidelines**

1. The ESMA Advisory Committee on Proportionality (ACP) was set up to advise ESMA on aspects of proportionality under its remit.
2. The ACP has assessed the ESMA Product Governance guidelines (the guidelines) to see whether proportionality is adequately taken into account.
3. The guidelines contribute to a core mission of ESMA: fostering investor protection across the Union. More specifically, they aim at facilitating the implementation of a fundamental change introduced to the European financial product distribution requirements set out in MiFID II. Manufacturers and distributors of financial products and services should ensure robust processes for the design of financial products and services, the identification of target investors (the “target market”) and the ongoing monitoring of distribution activities. Manufacturers should also oversee distributors and sub-distributors to ensure compliance with their distribution strategies. The guidelines have been in use since January 2018 and include explicit references to proportionality and the ACP considered them to represent a relevant topic for its first proportionality check, both from a design and implementation perspective.
4. The ACP notes – following the use of a survey carried out with NCAs – that in a few areas there is room to enhance proportionality in the guidelines and proposes that ESMA look into the following areas in the context of the review of the guidelines which is due by end 2022.
5. Firstly, although some feedback received by the ACP indicated that target markets are not always adequately defined by market participants, there is no evidence of proportionality shortcomings in the guidelines in this respect.
6. There seems to be, however, a recurring difficulty linked to observed approaches of clustering typically when instruments of too different profiles are put into the same cluster. The ACP would thus recommend that clustering is considered for further elaboration in the guidelines, with a view to introduce more clarity on how to apply a proportionate approach to clustering, where possible.
7. Secondly, on the issue of Regular Review, while the guidelines were well understood by most national competent authorities (NCAs) the ACP would see merit in addressing some requests made for clarity on how to apply proportionality in the context of the regular review. The guidelines could for example clarify or illustrate the reporting duties of distributors in relation to the financial instruments that are only available to clients under their own initiative execution only service and the time limit of the reviews in respect of financial instruments that were sold by the distributor in the past.
8. Thirdly, on the topic of hedging, although the ACP appreciates the fact that the guidelines are the result of a compromise, they would seem, on balance, to be sufficiently proportional. Nevertheless, the ACP encourages revisiting this point in the context of the

review of the guidelines as it seems that more elements in the field of hedging in portfolio management would benefit from clarification in a proportionate manner.

9. Fourthly, on the concept of the Negative Target Market, although some NCA's indicated that clarification on some areas, e.g., the "grey zone" would be appreciated, the ACP has not found any major evidence indicating significant difficulties in applying this part of the guidelines.
10. Lastly, the ACP encourages ESMA to consider how best to provide more illustrative examples on areas highlighted above.

### 3.4 Annex IV - Feedback on the consultation paper

1. Some respondents to the CP, including the SMSG, raised some general points on the draft guidelines, some of which are linked to broader issues related to the sustainable finance framework. The main general points are listed below.

#### *Consistency*

2. Various respondents, including the SMSG, noted the need for consistency in terminology and processes used. In particular, respondents encouraged alignment between the product governance guidelines and the suitability<sup>13</sup> and appropriateness guidelines<sup>14</sup>, and with existing industry associations' concepts that have become the industry standards such as the European MiFID Template (EMT). Moreover, the need for alignment between the terminology of the product governance guidelines and the PRIIPs framework was noted, and between the terminology used in the requirements relating to manufacturers and distributors.
3. ESMA agrees with the importance of consistency in terminology and processes used and stresses that this has been one of the guiding principles throughout the guidelines. ESMA notes that consistency has been considered not only within the product governance framework (e.g., the five target market categories that apply to both manufacturers and distributors), but also with respect to other frameworks. For this purpose, for example, ESMA provided the possibility for firms to align the concept of sustainability-related objectives with the concept of sustainability preferences as used in the suitability framework (paragraph 20), and clarified the importance of consistency of the concepts used in the target market assessment with those used in the point-of-sale frameworks (paragraph 42). Moreover, ESMA welcomes industry standards as they provide a way to implement the requirements and facilitate exchange of information between manufacturers and distributors. However, ESMA notes that such standards should be based on the relevant regulatory framework, including the guidelines, and not vice versa.

#### *Granularity of the target market*

4. Some respondents, including the SMSG, agreed that the target market should be sufficiently granular, but noted the need to strike a balance between granularity and practicability, efficiency, and the existence of an open architecture. In fact, it was noted that too much granularity may put an open architecture at risk (because only distributors from the same groups would be able to fully comprehend such detailed target market assessments), it would favour the largest players, and it would make an efficient feedback loop between distributor and manufacturer more difficult.
5. ESMA takes note of this comment and highlights that Commission Delegated Directive 2017/565 requires firms to identify the target market for each product at a sufficiently

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<sup>13</sup> ESMA35-43-3172

<sup>14</sup> ESMA35-43-2938



granular level. At the same time, the rules may be applied in a proportionate manner, which means that for simpler, more common products, the target market could be identified with less detail, while for more complex products, the target market should be identified with more detail. For example, ESMA illustrated how the proportionality principle could be applied for simpler products in case study 4 (see Annex VII).

### *Complexity*

6. Respondents noted the general need to avoid an excessive level of detail in the guidelines that would significantly increase the complexity of the MiFID II framework. Therefore, respondents suggested that ESMA should take a cautious approach and refrain from proposing an excessive level of detail in the guidelines where there is a risk of unintended consequences for retail investors. This was noted in particular with respect to sustainability, as complex rules and information overload can discourage retail investors from investing in sustainable products and also contribute to greenwashing, which would be counterproductive. In this regard, it was noted that ESMA could revise the guidelines at a later stage, when more ESG data and sustainable products will be available on the market.
7. ESMA has carefully considered the above comments and believes that the revised guidelines, in particular with respect to sustainability, ensure a sufficient level of granularity without being excessively detailed and do not add complexity to the MiFID II framework.
8. For example, ESMA notes the optionality of the approach outlined under paragraph 20. In fact, while firms are required to specify any sustainability-related objectives the product is compatible with, ESMA does not prescribe a specific approach to be used by firms. Instead, the possibility is provided for firms to align the concept of sustainability-related objectives with the concept of sustainability preferences. This optionality introduces flexibility, nonetheless it should be noted that firms should always comply with the overarching requirement to guarantee a sufficient level of granularity, also with respect to the sustainability-related objectives of the product.
9. Furthermore, this approach confirms ESMA's decision not to be more prescriptive and granular at this stage with respect to sustainability. ESMA notes that it will consider the development of further practical examples and explanations at a later stage, through different tools (such as Q&As) based on practical implementation of the requirements by firms and practical supervisory experience by competent authorities. ESMA confirms, once again, that it will continue its supervisory convergence efforts in this area even after the publication of the guidelines and using the various convergence tools it has available.

### *Timing and alignment issues*

10. Various respondents noted the complexity of the legal framework on sustainable finance and underlined that the misaligned timing of the different pieces of the EU's sustainable finance framework has been most unhelpful to the financial industry in implementing the new requirements. In this context, respondents requested ESMA to allow for a sufficient broad implementation period following the publication of the final guidelines. Furthermore, respondents noted the close connection between product governance and suitability and



raised concerns regarding the fact that the two sets of guidelines are not drafted, consulted on, and implemented simultaneously. Respondents noted that this poses practical problems as well as legal uncertainties since the two set of guidelines touch upon the same or similar legal definitions from different angles, raising concerns on their alignment. In this regard, it was suggested for the two sets of guidelines to be optimally aligned and to come into effect at the same moment.

11. ESMA notes that the application date of the new MIFID II requirements on product governance – 22 November 2022 - is set out in Commission Delegated Directive 2021/1269 and cannot be amended by ESMA. Nonetheless, mindful of the interconnectedness between the product governance and suitability frameworks, ESMA acknowledges that a concurring application date of the ESMA product governance and suitability guidelines would be helpful for firms' implementation. As the application date of the suitability guidelines is expected to be in October 2023, the application date of the product governance guidelines should be set accordingly. Therefore, ESMA has decided to set the application date of the product governance guidelines at the usual two months after the publication of the translation of the guidelines, which is expected to result in a formal application date reasonably aligned with that of the suitability guidelines.
12. With respect to the close link between the two sets of guidelines on suitability and product governance and the remarks on the misalignment in terms of timing on their drafting, in order to ensure alignment between the two, ESMA notes that it has based its approach on the review of the product governance guidelines on the approach just taken in the review of the suitability guidelines.

#### *Lack of data and risk of green bleaching*

13. Various respondents, including the SMSG, noted that a lack of data/unreliability of data makes it difficult for distributors and manufacturers to specify sustainability-related objectives of financial instruments. Moreover, respondents stated the current absence of reporting/disclosure requirements (e.g., due to a later entry into application of relevant legislation such as the Corporate Sustainability Reporting Directive or the Taxonomy Regulation).
14. In this respect, there is the risk that a lack and unreliability of data will have an impact on the process of defining the target market, leading to a situation where manufacturers will not be willing to expose themselves and in case of doubt will determine that the investment cannot be regarded as sustainable, which naturally will have a negative impact on the availability of sustainable products.
15. ESMA is aware that it may not be straightforward to calculate quantitative sustainability indicators due to the lack of reported data, or due to limits to the reliability of the necessary data. Nevertheless, ESMA is convinced that the situation is improving, as evidenced by the growing share of ESG data provided by data providers.
16. ESMA notes that the approach suggested in paragraph 20 of the guidelines leaves sufficient flexibility for firms to account for the challenges firms face when applying the sustainability-related product governance requirements. Moreover, the product

governance framework requires distributors to obtain adequate and reliable information about products from MiFID manufacturers, and to take all reasonable steps to obtain such information about products from non-MiFID manufacturers. This also applies to products that consider sustainability factors.

#### *Review obligation*

17. A few respondents expressed the concern that the CP does not address the issue regarding the review obligation for firms that qualify as manufacturers when advising corporate issuers on the launch of new products (Recital 15 of Delegated Directive 2017/593). Such firms receive fees for providing services like advice, underwriting and placing of securities, but there are no ongoing fees received after the transaction. Moreover, respondents noted it would not make sense to qualify the firm having advised on the last capital increase, or former capital increases, as the manufacturer of all outstanding securities. Respondents suggested ESMA to adopt a proportionate approach, in which firms advising corporate issuers on the launch of new products should not be subject to the review obligations for manufacturers. It was suggested that, should this not be possible because of the scope of Level I, ESMA should at least give such a clarification in relation to simpler products or clarify that reviews could be more generic on the type of products and not on individual products.
18. ESMA takes note of the input received and acknowledges that manufacturers may face challenges when reviewing products on which they advised corporate issuers when such products were launched. According to ESMA, a manufacturer that has advised a corporate issuer on the launch of a new product, may apply the review obligation for that product in a proportionate manner, irrespective of whether it concerns a simpler or more complex product. This has been added to paragraph 68 of the guidelines. However, in light of the Level II requirements, the review obligation cannot be disapplied completely. ESMA wishes to highlight this issue to the Commission and recommends evaluating whether the review obligation applicable to a firm that has advised a corporate issuer on the launch of a new product should be further softened.

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

19. While some of the respondents agreed with the amendments to the guidelines requiring additional explanations about the choices made in the context of product governance (i.e., paragraph 13), many respondents noted that this will impose a greater burden on manufacturers and distributors without a clear effect on investor protection (especially when dealing with non-complex products). In this context, respondents underlined the need to apply the proportionality principle (i.e., only requiring what is necessary to understand the central reasoning for the choices made) and noted that these additional burdens should only be imposed by the guidelines if the lack of those obligations has led to a negative impact on investor protection in the past. Furthermore, respondents noted that the

requirements would imply a massive increase in the documentation to be kept in the entity's records. The SMSG in particular required more guidance on what it is meant with “substantiate and document” the choices made (i.e., paragraph 20 of the background section of the CP).

20. ESMA takes note of the above comments but does not consider that additional guidance would be necessary in paragraph 13 of the guidelines. As outlined in the CP, the clarification added in paragraph 13 is suggested based on the outcomes of the 2021 CSA, which showed that firms often provide limited or no explanation on relevant choices made. The CP reports some examples of relevant choices, such as the choices made in determining the compatible distribution strategy for the product and the way in which the firm will monitor whether a product is reaching the intended target market. Nevertheless, ESMA wishes to note that paragraph 13 of the guidelines, as the product governance framework in general, applies with the principle of proportionality. Substantiation of relevant choices made is more relevant in relation to more complex products, and less in relation to simpler products.
21. Several comments were also provided on paragraph 14, where ESMA clarified that, for the purposes of the target market identification, manufacturers should also take into account the results of the scenario and charging structure analyses undertaken for the relevant product. In particular:
  - Clarifications were requested in relation to what “the charging structure analyses” entail, they were also requested by the SMSG.
  - Some respondents, including the SMSG, noted that scenario analyses are already required by PRIIPs and there should be no need for a separate target market scenario analysis for the purposes of product governance also to avoid the risk of divergent results between manufacturers. Furthermore, respondents’ opinion is that the cost assessment should be a separate exercise to the target market identification, and that the responsibility of the manufacturer should be to disclose the impact of costs on the product return based on the PRIIPs simulation and the KID cost table, in order to ensure comparability across products. Concerning non-PRIIPs instruments (e.g., shares, bonds, ...) respondents noted that the guidelines should clarify how such a scenario analysis should be performed.
  - Respondents also requested clarity on how to integrate the outcomes of the scenario and charging structure analyses for a given product into the target market. In this regard, it was noted that the assessment of the charging structure is part of the product governance process, as it is taken into account during the manufacturing of each product in order to ensure that its fee structure is compatible with its risk-return profile. However, it is unclear how this analysis should also be translated into the target market assessment.
22. ESMA wishes to clarify that the terms “scenario” analyses and “charging structure” refer to the analyses required under respectively Article 9(10) and (12) of the MiFID II Delegated

Directive. This has been clarified in the guidelines. Furthermore, ESMA stresses that these requirements apply to any product (PRIIP or non-PRIIP) manufactured by firms.

23. Some respondents also provided comments in relation to the requirement under paragraph 14 to consider qualitative considerations when identifying the potential target market. Respondents noted that, as far as qualitative considerations are concerned, lengthy narratives may not be a proper way of assessing the target market of millions of structured products in a consistent way across the EU. Automation and quantitative assessment are relevant to product a target market that is concise, objective, and comparable against other products' target market. They noted that, so far, the practical experience is that the automation of target market has allowed for a consistent reporting of sales in negative target market across distributors.
24. ESMA has carefully considered the above comments and is of the opinion that no adjustments are necessary to paragraph 14. Qualitative considerations should be taken into account to determine the target market, but this does not mean that the final result cannot be concise.
25. In relation to paragraph 16 regarding the requirement to not merge target market categories, some of the respondents noted there is no reasoning or justification for such prohibition as, based on the principle of proportionality, it should also be possible to merge certain criteria of the target market determination where the structure of the financial instrument and the potential investor audience permits. Respondents therefore suggested including an exemption to the clarification added in paragraph 16 to allow for merging when the complexity of the product and/or the targeted potential investors justifies a simplified target market determination.
26. ESMA takes note of the above comment. However, ESMA re-states the importance of non-merging target market categories when identifying the target market, as specified under paragraph 16, as merging (e.g., specifying clients' financial position and risk tolerance within one category) could result in an insufficient consideration of the different categories, also in case of simpler products.
27. With regards to the amendments made to paragraph 19 a), respondents agreed on the requirement for the decision to market or distribute a product exclusively to eligible counterparties should be made ex-ante. Even so, ESMA wishes to clarify that the reference to "ex-ante" should be understood as pertaining to the target market assessment stage, as well as the review stage (in which case the distributor could decide to change the distribution strategy to eligible counterparties only).
28. In relation to the amendments to the target market category "Risk tolerance and compatibility of the risk/reward profile of the product with the target market" (paragraph 19 d), the following was noted:
  - The SMSG noted that the terminology used in the paragraph is not aligned with the wording of industry standards, which the SMSG deems important, and should only deviate from the industry standards if there are good reasons for doing so, which should be clearly explained.

- Regarding the terminology, the SMSG noted that one of the terms used as an example in the guidelines is “conservative”. However, the SMSG is of the opinion that this term is not clear and may even be misleading and suggested the use of the term “risk-averse”, which in the SMSG’s opinion expresses more directly what is actually meant and is a term which the average investor will understand better.
  - The SMSG has also debated on the question whether, in the context of the risk/reward profile of the product, the basic risk attitudes of investors should be standardised. The SMSG notes there is already a high level of standardisation in terms of the industry standards. The SMSG believes that at least five risk categories are needed in order to have sufficiently meaningful distinctions between different types of investors, and noted it is of the utmost importance that the basic risk attitudes of investors used in the target market description of product manufacturers are easily translated into investor risk profiles by the distributor under the suitability test.
  - Many of the respondents do not agree with the possibility to consider additional relevant risks that may not be measured by the PRIIPs and UCITs risk indicators. In particular, it was noted that these risk indicators are appropriate measures, calculated in accordance with very detailed methodologies and should be considered as an accurate risk measure. Moreover, respondents noted the necessity to identify a single example of an indicator to be used as a reference, to avoid the risk of increasing confusion and not protecting consumers, leading to a situation where every firm establishes its own methodology, reducing its comparability.
  - With reference to the example of currency risks included in the guidelines, it was noted that currency risk depends on the country in which the product will be marketed and therefore such risk assessment should have to be carried out on the distribution side. This was also noted by the SMSG, which noted that, if product manufacturers would need to take this into account, they would have to produce different target market descriptions for potential target markets in Member States with different currencies and consider that this example is not adequate for the target market requirements for product manufacturers. The SMSG considers that warning against possible currency risk should rather be the responsibility of the product distributor, who could include this in the description of the actual target market, if relevant. The SMSG suggested the product manufacturer might refer to a “reference currency” in terms of historic volatility of the product.
  - Moreover, it was noted by respondents that the PRIIPs indicator does in fact include considerations regarding currency risk.
  - Lastly, respondents noted that, in respect of the SRRI, a note should be added (e.g., in a footnote) that this will presumably only play a subordinate role (if not become fully obsolete) once the PRIIP Regulation is extended to include funds from 1 January 2023.
29. ESMA has carefully considered the comments received in relation to paragraph 19 d). ESMA agrees on the importance to ensure the comparability of target markets. In this context, ESMA would like to highlight that the terms used within the different target market

categories, such as a “conservative” risk attitude, should be seen as examples and not as templates/terms that should be used by firms. What is important though is that firms use well-defined terms in their product governance arrangements. As to the risk profile of the product, ESMA agrees that there should be alignment to risk information included in the PRIIPs KID, where relevant. However, not all materially relevant risks for a given product may be included in the summary risk indicator. Under the PRIIPs regulation, such risks should be included in the narrative explanations below the summary risk indicator. ESMA considers that firms should, where relevant, in addition to the summary risk indicator, also take into account the other materially relevant risks included in the narrative explanations. Paragraph 19 d) of the guidelines has been amended to clarify this point.

30. While consumer organisations agree with the requirement in paragraph 19 e) for firms to always specify the expected investment horizon for a product when determining the target market’s objectives and needs a product is compatible with, some comments were provided by other respondents. In particular, regarding the reference to “years”, it was requested more flexibility should be granted (i.e., the possibly to use time bands such as “short”, “medium” and “long term”). It was also noted it will be very difficult to define an investment horizon in years for products without a fixed term, such as funds or shares (e.g., in the case of share respondents noted such information might be misleading for the consumer as it might give the impression that its price performance is especially positive in the year in question). In this context, other respondents, including the SMSG, suggested ESMA to align the guidelines with EMT terminology which refer to “minimum investment horizon” to not introduce terminology that deviates from widely used industry standard. ESMA took note of the above comments but decided not to introduce any amendments to the guidelines on the requirement for firms to reference an expected investment horizon/recommended holding period of a product.
31. Some respondents also commented on the optional requirement to “fine-tune” the investment objectives of clients. They noted that this is not provided for in the legislation and that it will be very difficult to make a statement at manufacturer level that a product is aimed at, for example, a certain age group.
32. ESMA takes note of these comments but highlights the optional nature of this guidance; indeed, where necessary, ESMA considers that manufacturers should be able to fine-tune clients’ investment objectives the product is compatible with. In practice, this means that, based on the proportionality principle, in case of products that are particularly complex or characterised by innovative features, the target market could deserve to be described in a more detailed manner, to allow for a better identification of clients to be targeted.

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

33. Although most of the respondents welcomed the alignment of the definition of “sustainability-related objectives” with the definition of “sustainability preferences”



according to Article 2(7) of the MiFID II Delegated Regulation, several comments were provided with respect to the wording of paragraph 20 of the guidelines. In particular, the following was reported by respondents:

- The SMSG welcomed the optionality of paragraph 20 concerning the alignment with the definition of ‘sustainability preference’ under the suitability guidelines and identified several drawbacks in replacing “may” with “should”. For example, it was noted that due to data scarcity, it will not always be possible to provide those specifications, whereas for certain products, it will not even be relevant to do so. Moreover, the SMSG noted that an obligation for firms to specify the sustainability-related objectives would create difficulties in the feedback process on those aspects (as firms should then have processes allowing them to give feedback to the manufacturer on all those aspects), that are at present difficult to overcome. In addition to the comments provided by the SMSG, the optionality of the requirements was welcomed by many of the respondents.
- Diverging comments were provided in relation to the interpretation of the scope of sustainability-related objectives. Most of the respondents agreed that the definition of sustainability-related objectives should not be limited to the definition of sustainability preferences introduced under MiFID II, to allow to capture the broad spectrum of sustainability preferences of clients that exists in practice. In this context, the following was noted:
  - a) Most of the respondents agreed that the definition of sustainability-related objectives should be broad and welcomed the third bullet point of paragraph 20, which provides the possibility to investment firms to specify any environmental, social or governance aspects of the product. It was indeed noted by respondents that this additional optional category allows firms to specify sustainability-related objectives as part of the target market where they cannot be attributed to one of the three categories of “sustainability preferences” defined by Article 2(7) of the MiFID II Delegated Regulation (e.g., where technical screening criteria for a certain environmental objective do not yet exist).
  - b) In this regard, it was also suggested that the concept of sustainability-related objectives should be interpreted even in a broader way and should be interpreted to cover aspects relevant to the sustainability goals/objectives of clients (e.g., value alignment, achieving impact, etc.).
  - c) In contrast to the above, a few respondents did not welcome this addition, stating that firms should not be expected to assess if the products have a focus on either E, S or G criteria as such an assessment of clients’ ESG preferences is not required by the MiFID II Delegated Regulation and should not be conducted on products either.
- Furthermore, some respondents noted that the alignment of the definition of “sustainability-related objectives” with the definition of “sustainability preferences”

according to Article 2(7) of the MiFID II Delegated Regulation, should be considered only when providing of portfolio management and investment advice. It was underlined that, when providing non-advised services, investment firms do not have access to relevant information that allows them to assess the target market in relation to a client's sustainability preferences. For this reason, some respondents suggested that, when providing services other than portfolio management and investment advice, the assessment of the target market should be limited to specifying whether the investment is intended for clients with certain sustainability preferences. In this context, some respondents noted that the third optional category introduced under paragraph 20 of the guidelines may become particularly relevant in the case of non-advised sales.

- Finally, some respondents noted that the sustainability-related objectives are already accounted for in the current template used by the market (i.e., the European MiFID Template) and therefore also support the discretion in the application of paragraph 20 of the guidelines.

34. ESMA has carefully considered the above comments and has decided to not further amend paragraph 20 and to maintain the wording that was included in the CP. With this wording, ESMA confirms the requirement for firms to specify any sustainability-related objectives the product is compatible with, but gives firms the optionality to align the target market with respect to the sustainability objectives of a product with the definition of sustainability preferences under suitability. In particular, ESMA considers that the current wording guarantees a sufficient level of granularity and also ensures consistency and alignment with the requirements on suitability.
35. As to the question outlined under paragraph 27 of the background section of the consultation paper on whether a manufacturer should specify sustainability-related objectives of a product by referring to the sustainability data of either the issuer of the product, or the product itself, respondents, including the SMSG, noted that there is no one size fits all-approach and that it should be possible to apply the two options separately or in combination (e.g. in the case of structured securities).
36. ESMA takes note of the comments provided by respondents on this specific point but decided to not further amend the guidelines at this stage to avoid being too prescriptive and to allow firms to adopt a flexible approach. ESMA takes the opportunity to note that it will consider the development of further practical examples and explanations at a later stage, through different tools (such as Q&As) based on practical implementation of the requirements by firms and practical supervisory experience by competent authorities. ESMA confirms, once again, that it will continue its supervisory convergence efforts in this area even after the publication of the guidelines and using the various convergence tools it has available.
37. Lastly, some respondents noted the need to add a reference to the new paragraph 20 in paragraph 42, to ensure that sustainability-related objectives are considered by the distributor when defining the target market.



38. ESMA takes note of this comment and has amended paragraph 42 accordingly to clarify that distributors should use the same list of categories used by manufacturers (including paragraph 20) as a basis for defining the target market for their products.

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

39. Respondents provided comments to ESMA's request for input<sup>15</sup> on whether there are categories of financial products for which the reference to minimum proportion would not be possible. In this regard, ESMA requested input on the possibility to handle the concept of "minimum proportion" with some flexibility by referring to the actual proportion instead of the minimum one. Many respondents, including the SMSG, provided input on this question. However, it should be noted that the SMSG doubts whether it should be addressed in the context of MIFID II product governance guidelines.

40. In terms of input received, most of the respondents, including the SMSG, fully share ESMA's analysis that the concept of "minimum proportion" does not apply to financial instruments for which it is not practically possible to define such minimum proportion. They noted that, instead, these types of products could indeed refer to the actual proportion instead of the minimum proportion. In this regard, some respondents proposed this approach to be explicitly outlined and incorporated directly in the guidelines instead of having it outlined in the background section.

41. In the context of the minimum proportion, the SMSG was of the opinion that a distinction should be made between what is theoretically impossible and what is for the time being impossible from a practical point of view. In particular, the SMSG highlighted the following problem areas with respect to a number of instruments:

- Shares / Bonds / Structured securities. These financial instruments are not in the scope of the SFDR. Therefore, any "minimum proportion" requirement for financial products deriving from the templates set out in the Annexes to Delegated Regulation (EU) 2022/1288 does not apply to those financial instruments which do not qualify as financial products under the SFDR regime. The SMSG sees no legal basis for extending this requirement to these financial instruments within the context of the MiFID II product governance framework. E.g., most structured securities are – different from an investment fund – not actively managed during their life cycle. For these financial instruments, it is hardly possible for an issuer to give any commitment on keeping a minimum proportion from issuance to maturity. Hence, the information on the actual proportion at the moment of issuance should be sufficient.
- Private equity funds / infrastructure funds. These funds play a pivotal role in the transformation towards a more sustainable economy. However, they often have a fund of fund structure. Hence, "minimum proportions" can only be defined if each of the underlying funds is able to define minimum proportions, which is for the time being,

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<sup>15</sup> Please refer to the Consultation Paper (ESMA35-43-3114), paragraph 26 of the background section and footnote 13.

rarely the case. As a result, the SMSG identifies a risk of green bleaching with respect to these funds as they may refrain from claiming a minimum proportion of sustainable assets, even if they have.

- Residential Mortgage-Backed Securities. Given the fact that banks will need to report on their climate risk in the next few years, one can imagine that credits for energy-inefficient residential mortgage will be increasingly securitized. For this reason, it would be fair that the investor knows to what extent the underlying loans are for energy-inefficient / -efficient mortgages and have a higher/lower climate risk. This requires data. Moreover, neither the Taxonomy Regulation nor the Sustainable Finance Disclosure Regulation at present incorporate criteria to judge the sustainability of residential real estate, making it not only practically (data) but also theoretically impossible to judge the degree of sustainability of RMBS.
- Social bonds/sustainable bonds. There are certain market definitions (for instance by ICMA), but the legislative definition of social bonds / sustainable bonds may be tricky, so that it is difficult to define what the minimum proportion should be. Moreover, it would be even more difficult to agree on minimum proportion on a global level.

42. A number of respondents agreed with the SMSG's view in respect of these instruments. In particular:

- Respondents identified shares, bonds and derivatives as the main instruments to which the concept of minimum proportion would not be practically applicable since these instruments have no contractually guaranteed minimum value. Therefore, respondents agreed that the actual proportion should be used instead of the minimum proportion for these instruments.
- The difficulty to calculate minimum proportions for private equity funds and funds of funds were also mentioned by some respondents, including the SMSG (as reported above).
- Moreover, some respondents noted that for some derivatives (e.g., derivatives used for hedging purposes), and for securitised assets and commodities not only the concept of minimum proportion but also the concept of sustainability-related objectives would not be applicable. This was also highlighted with respect to sovereign bonds, as there is currently no methodology to assess sovereign bonds against the Taxonomy Technical Screening Criteria.
- Nevertheless, respondents, including the SMSG, agree on the need to develop clear methodologies in order to assess the contribution of derivatives to taxonomy-aligned economic activities.
- Diverging opinions were, however, provided in relation to structured investment products. While some respondents noted that there is no methodological difficulty in

applying the concept of minimum proportion to such products, others highlight a difficulty in calculating their sustainability-related objectives.

43. ESMA has carefully considered the input received. ESMA would like to note that, as outlined in the consultation paper, even though the term ‘minimum proportion’ is derived from the SFDR and the Taxonomy Regulation, in the MiFID context it should be read in a broad sense (i.e., possibly also applying to products with sustainability factors that are not in scope of the SFDR and/or the Taxonomy Regulation). However, ESMA shares the SMSG’s doubts on whether it should be addressed in the context of MiFID II product governance guidelines. However, as previously noted, ESMA will consider the development of further practical examples and explanations on a later stage, through different tools (such as Q&As) based on practical implementation of the requirements by firms and practical supervisory experience by competent authorities. ESMA reconfirms, that it will continue its supervisory convergence efforts in this area even after the publication of the guidelines and using the various convergence tools it has available. Moreover, ESMA notes the concerns raised by the SMSG regarding the current difficulty concerning private equity funds and funds of funds. Nevertheless, when firms choose to identify the sustainability-related objectives of the product in line with the definition of “sustainability preferences” under the MiFID II Delegated Regulation, ESMA reminds firms that, for products in the scope of SFDR, firms should apply the concept of “minimum proportion”.
44. Respondents also noted the current difficulties in obtaining the necessary data that will allow calculating the relevant proportions, as already outlined under paragraph 34. Firms asked for the guidelines recognise flexibility for firms in the definition of the ESG target markets by using alternative data, provided for example by third party data providers.
45. ESMA takes note of this comment and, as mentioned under paragraph 34 above, confirms it is aware that it may not be straightforward to calculate quantitative sustainability indicators due to the lack of reported data, or due to limits to the reliability of the necessary data. Nevertheless, ESMA is convinced that the situation is improving, as evidenced by the growing share of ESG data provided by data providers.
46. Some additional comments were provided in relation to the methodology to be used to assess the sustainability-related objectives of a product:
- Some respondents noted that the information to determine the target market should come from the company itself and should not be calculated by the distributor in order to avoid discrepancies in the market.
  - Others noted that manufacturers and distributors should be free to define the best methodology to assess the sustainability-related objectives of a product, in the current absence of prescribed methodology and suggested that ESMA could revert to the question of harmonised calculations at a later stage.
47. Lastly, respondents highlighted the need for the guidelines to provide clarity in relation to the possibility for firms to deviate from the target market with respect to the assessment of the minimum proportion concerning sustainability-related objectives outlined under

paragraph 20 of the draft guidelines when providing investment advice with a portfolio approach or portfolio management.

48. ESMA has considered the comments received and has amended paragraph 62 to clarify that the approach outlined in the paragraph regarding sales outside of the product target market in the case of diversification and hedging could also be applied to the sustainability-related objectives of the product. ESMA has clarified that this approach is valid when it is consistent with the one outlined in the ESMA suitability guidelines (i.e., confirming that the assessment at the point of sale of sustainability-related objectives by distributors, including the minimum proportion (where applicable), can be based on a portfolio approach when providing investment advice or portfolio management).

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

49. Although some respondents supported ESMA's suggested guidance on complexity in relation to the target market assessment and the clustering approach, seeing the guidance as a move towards more proportionality in the determination of the target market, a number of comments have been provided by respondents, including the SMSG, on the amendments introduced.

50. In particular, in relation to the guidance on the assessment of the complexity of the product and the identification of the level of detail of the target market introduced under paragraph 24, several comments were provided by respondents, some of which are summarised below:

- The SMSG suggested a redrafting of paragraph 24 to avoid introducing vague statements, as follows: *"In this context manufacturers should determine the level of complexity of manufactured products, amongst other things by taking into account the criteria and principles identified in article 25 (4) MiFID II. The level of complexity of the product will help the manufacturer in determining the adequate level of detail of the target market description"*.
- Moreover, the SMSG, as well as some other respondents, also noted that additional guidance is needed on what elements firms should consider when determining the level of complexity of products. In this context, some respondents noted their disagreement to the introduction of complexity as a relative term by ESMA in the guidelines. Instead, they suggested ESMA to either refrain from using complexity as a relative concept or to clarify the definition of complexity legally, since the lack of a definition creates a great level of legal uncertainty.

51. ESMA has taken note of the above comments but has decided not to change paragraph 24 of the guidelines. A product's level of complexity is a key factor in determining its target market. Moreover, as it should be understood in a relative sense, it should not simply be equated to the criteria and principles of Article 25(4) of MiFID II, even though those criteria and principles should also be taken into account in the complexity assessment. Lastly,

ESMA wishes to highlight that this approach to complexity is consistent with the one included in its suitability and appropriateness guidelines.

52. In relation to paragraph 26, which requires a very careful target market assessment for products with a particularly complex and risky nature, such as contracts for difference (CFDs) or products with similar characteristics, the following comments were submitted:

- The SMSG commented on paragraph 26 and in particular to the reference that for certain particularly complex and risky products, such as contracts for difference (CFDs), there might not be a compatible target market at all. The SMSG agrees that certain products should not enter the market. However, the SMSG notes that product manufacturers should have procedures in place in the product design phase to avoid the creation of products for which no compatible target market would exist. The SMSG advises ESMA to reflect this aspect in the guidelines, rather than suggesting that such products would be designed, after which “no compatible target market” would be assigned to them.
- In this regard, respondents also noted that CFDs can have a compatible target market for retail investors, when meeting certain criteria, and asked ESMA to remove the reference in paragraph 26 to the possibility that no compatible target market would exist for CFDs. Respondents noted this statement is unjustified and extreme, noting that the increased regulatory and supervisory focus on CFDs over the past years had led to an improvement of the characteristics and transparency of the product.

53. ESMA has carefully considered the above comments but has decided to confirm the proposed approach outlined under paragraph 26 of the consultation paper, with some clarifications considering the input received. The risk of mis-selling being especially pronounced for more complex and risky products, ESMA considers that the target market and distribution strategy assessment should be most rigorous for such products. ESMA considers that this principle should be reflected in the outcome of firms’ target market assessments for such products, which has been clarified in the guidelines. In this regard, ESMA identifies certain products, such as contracts for difference (CFDs) or products with similar features as particularly complex and risky.

54. Several comments were provided in relation to the paragraph concerning the use of a “clustering approach” in the definition of the target market by manufacturers and with particular reference to paragraph 27. This paragraph requires manufacturers to pay particular attention to the level of complexity of products, meaning that the more complex the underlying products of a cluster become, the more granular the clustering should be and outlining the expectation that for certain more complex products, such as certain OTC derivatives or structured products, a clustering approach will not be appropriate. The main comments are reported as follows:

- The SMSG advised to redraft paragraph 27 as follows: *“In ensuring that homogenous clusters are identified, firms should pay particular attention to the level of complexity of*

*products, meaning that also for more complex products the cluster should be homogenous and therefore the clusters may need to be more granular”.*

- Overall, some respondents agreed with the amendments introduced in the guidelines. However, many respondents noted that, while agreeing on the importance of the proportionality principle to determine the level of detail with which the target market should be identified, a certain degree of standardisation is needed also for complex products and therefore a clustering approach could work on some aspects also for them.
- In particular, many respondents disagreed with the exclusion of OTC derivatives or structured products from the clustering approach and proposed not to reflect the exclusion of OTC derivatives or structured products in the final guidelines. With specific reference to OTC derivatives and structured products, the following comments were provided:
  - a) Respondents noted that the requirements set out in paragraph 27 that “homogenous clusters” must be identified and that “the more complex the underlying products of a cluster become, the more granular the clustering should be” are prudent standards for the target market definition which can be applied to all asset classes while a per se exclusion of certain asset classes on general terms without a material assessment of the specific product governance process of a specific manufacturer by the competent authority seems neither necessary nor justified.
  - b) Moreover, respondents explained that in both types of products the different products available on the market are by practical necessity highly standardised and only certain product features such as term or underlying of the instrument may differ while the main product characteristics and risk factors remain unchanged. Furthermore, it was highlighted that, as manufacturers typically issue a large number of such products, a high degree of operational automation of the issuance process is required which, in turn, leads to the standardisation of product features enabling a uniform assessment approach for the target market. Moreover, it was noted that from a technical point of view the implementation of a clustering approach does not restrict the manufacturer to define specific target market criteria on a product level, if necessary, such as for example the tailoring of the risk level or risk/reward profile of an instrument.
  - c) Furthermore, it was noted that the proportionality approach also justifies that the clustering approach for products which are not marketed to retail clients can be applied with less granularity and this particularly applies to OTC derivatives distributed to professional clients and eligible counterparties.

55. ESMA takes note of the above comments and confirms the proposed approach under paragraph 27. ESMA would also like to highlight that the paragraph clarifies that firms should pay particular attention to the level of complexity of products when identifying a



cluster, as more complexity requires more granularity. Furthermore, ESMA would like to clarify that the guidelines do not introduce an exemption to the use of clustering approach with regards to OTC derivatives or structured products but highlight that for certain more complex products (such as certain OTC derivatives or certain structured products) a clustering approach might not be appropriate. Nevertheless, to avoid confusion, ESMA decided to delete the reference to certain OTC derivatives and structured products.

56. Paragraph 28 introduces multiple key factors that manufacturers should consider when clustering products. Generally, respondents considered the key factors for clustering useful. But they did ask ESMA to clarify that these factors should be understood as non-mandatory and not cumulative, in order to allow for a certain degree of flexibility in the clustering approach and to allow for proportionality when dealing with non-complex products. Instead, other respondents noted they would prefer an exhaustive list as it will permit to implement the suggested approach with no legal uncertainty.
57. ESMA confirms that the list of multiple key factors to be considered is illustrative but stresses that it conveys the expectations as to the level of granularity to be used. Moreover, depending on their relevance for specific products, factors should be used in a cumulative manner.
58. Regarding paragraph 29, which outlines the requirement for manufacturers to consider the outcomes of the charging structure and scenario analyses of each product when using a clustering approach, respondents noted they would benefit from more guidance and practical examples on how to consider these outcomes. In particular, it was noted that there might be cases when the consideration of the charging structure and scenario analyses might prevent the use of a clustering approach (for example fund managers could create a cluster concerning ESG impact funds which partially invests in taxonomy-aligned investments – in this case the charging structure and scenario analyses of each product may vary, affecting the clustering approach).
59. Lastly, respondents noted that sustainability-related objectives to the definition of target markets adds a layer of complexity when operating the clustering approach. This will also impact earlier defined clusters, which may be homogenous in risk/ return characteristics, but could differ widely in sustainability-related objectives. Consequently, respondents noted it could become difficult to apply any clustering at all. In this regard, respondents noted they would welcome some examples of how to group similar financial products based on their sustainability-related objectives.
60. ESMA agrees that providing examples on the clustering of products with sustainability-related objectives would be useful but considers it premature at this stage as firms' approaches are still developing.

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

61. Some respondents, including the consumers organisations, welcomed ESMA's proposed amendments to paragraph 34 to 40 of the guidelines. They agreed that the target market

assessment should be conducted at an early stage as part of the firm's general decision-making process, and that, at that same early stage, firms should consider what distribution strategies should be used for the different client groups, including the way in which products will be marketed to clients. These respondents viewed it positive that ESMA takes into account new developments such as behavioural finance and gamification as part of the distribution strategy. A few of them indicated that where firms use such forms of distribution, a conscious decision should be made, and firms should avoid that behavioural finance and gamification techniques create false incentives for clients.

62. Some respondents, however, requested ESMA to clarify the terms behavioural finance and gamification, and to make clear what forms of gamification techniques are allowed and what not. In this context, a few respondents highlighted that behavioural finance and gamification techniques can also be used to improve the relationship with clients, by allowing to take behavioural profiles into account when taking investment decisions and reducing common biases and mistakes. Others argued that some forms of behavioural finance and gamification techniques used as part of a firm's business model, such as presenting products in an attractive manner to clients, should be allowed. A consumer organisation, conversely, welcomed ESMA's reference to the harmful nature of gamification techniques aimed at maximising the number of trades and noted that it remained unclear what other forms may exist. The SMSG, furthermore, recommended ESMA to replace "behavioural finance" with "nudging", which more accurately captures the objectives of such practices. A few respondents also requested ESMA to clarify why the guidance provided in paragraph 35 and 39 is different from the determination of the distribution strategy for the product.
63. A few respondents expressed the view that the introduction of new requirements to assess the consistency of products and services offered to clients, beyond existing practices, would be excessively burdensome without clear effects on investor protection. A few respondents were also concerned that ESMA's suggestions could lead to the creation of barriers and limitations in the distribution of certain products for certain client groups. In their view, there should always be a possibility to deviate from the target market for portfolio allocation. A few respondents also questioned the legal basis for requiring firms to consider behavioural finance, gamification and the client's choice environment as part of the distribution strategy. In their view, the distribution strategy should be related to advised services, appropriateness or execution-only.
64. Having considered the above comments, ESMA confirms the overall approach in paragraph 35 and 39 of the guidelines. ESMA agrees with the SMSG's remark on the term "nudging" and has substituted this for "behavioural finance". ESMA also acknowledges that "digital engagement practices" can encompass a wide spectrum of techniques, which can be both harmful and beneficial for clients. At the same time, ESMA considers that to specify what kind of digital engagement practices should be allowed and what should not, would go beyond the scope of these guidelines. Generally speaking, ESMA considers that firms should avoid using any digital engagement practice nudging clients to trade excessively and/or to invest in more complex and/or risky products.



65. The SMSG expressed the view that the actual target market definition of individual products would not be the task of the management body and cannot take place at the same time as the determination of the firm's business policies and distribution strategies. On the basis of determining the latter, the management body could identify the types of products and range of potential target markets that could match the different client groups the firm will cater to. However, the actual choice of concrete products to be included in the product offer and the actual target market identification should be determined afterwards based on such general policies and strategies. As a related point, a few respondents were of the opinion that the reference to "management board" in paragraph 34 should be replaced with "senior management" because the management board would not be involved in defining the actual target market for products, even though it is responsible for defining the distribution strategies in general terms.
66. ESMA agrees that the firm's management board, while responsible for the firm's business policies and distribution strategies, does not have to be involved in the actual target market definition of products, although products' target market needs to be identified in accordance with the policies and strategies adopted by the management board. To avoid confusion, ESMA has decided to better clarify the reference to the firm's management board in paragraph 35 of the guidelines, while keeping the reference to the ex-ante nature of the actual target market assessment. Indeed, ESMA stresses that the actual target market assessment by the distributor should be done before going into daily business and/or before deciding whether the product should be included in the firm's offer.

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

67. Some respondents, including a consumer organisation, agreed with ESMA's proposals. They agreed that distributors should translate the manufacturer's target market assessment into language that fits their own distribution processes.
68. On paragraph 42 of the guidelines, a few respondents highlighted the risk of too much granularity. The SMSG, for example, while agreeing that target markets should be sufficiently granular, indicated that too much granularity may put the continued existence of an open architecture at risk. Moreover, if the terminology used by manufacturers is not harmonised, the task of ensuring consistent terms and definitions in the actual target market definitions is almost impossible for distributors. According to the SMSG, the only solution is standardisation, which will facilitate communications between manufactures and distributors. Thus, ESMA should stimulate this process and make sure that it uses the same market standards in its own regulatory work. A few others argued that the target market assessment should not replace the suitability assessment, proposing to substitute "could, where relevant, adopt" for "should adopt". Moreover, a few respondents noted that paragraph 42 should not only relate to paragraph 19, but also to 20.

69. ESMA has taken note of the above comments and decided to amend paragraph 42 to clarify that distributors should use the same list of categories used by manufacturers (including paragraph 20) as a basis for defining the target market for their products.
70. Many respondents expressed concerns about ESMA's proposal in paragraph 46 of the guidelines. According to these respondents, requiring distributors to get access to underlying documents to the manufacturer's target market assessment would be too demanding, and difficult to implement in mass retail business and in cases where there is no contractual relationship with the manufacturer. Moreover, sharing documents such as the outcomes of the manufacturer's scenario analysis and charging structure analyses, which would relate to proprietary internal methodologies, would be difficult due to business secrecy constraints and competition rules. A few respondents also pointed to the issue of products not manufactured by MiFID firms, expressing the concern that in such cases the distributor would be required to perform their own analyses. Based on these concerns, suggestions to change the paragraph include to add "were appropriate" or making it a possibility or good practice. One respondent suggested the following wording: "distributors should also determine whether, next to the manufacturers' target market description, they need access to more information or explanation from the manufacturer on the scenario calculation or on the charging structure analyses".
71. The SMSG highlighted that the determination of the actual target market by the distributor is an enormous task, and that the distributor cannot check every detail. This means that the actual target market definition should come down to a sanity check consisting of two elements: checking whether the potential target market definition by the manufacturer is manifestly incorrect, and assessing whether the potential target market definition fits the distributor's client base or whether refinements are needed.
72. ESMA acknowledges the concerns expressed by respondents and wishes to highlight that the proposed paragraph 46 of the guidelines clarified that distributors, when scrutinising the manufacturer's target market for more complex products, need to determine whether they need access to such underlying document, and not that distributors should, in all cases, need access to such underlying documents. For this reason, ESMA deems that no amendments are necessary.
73. Regarding paragraph 47 of the guidelines, some respondents welcomed ESMA's proposal to make the clustering approach also available to distributors. At the same time, some of them pointed to a risk of excessive granularity of key factors, which would not correspond to existing client types, and expressed the view that more flexibility should be allowed. A few respondents also indicated that the consideration of the charging structure should not be part of the target market assessment, with one of them questioning the added value of taking into account leverage used in certain UCITS, considering that UCITS are non-complex in most cases and are made available to retail investors.
74. ESMA notes the support for making the clustering approach available to distributors as well as manufacturers. The clustering approach can facilitate distributors target market assessments, by performing the target market assessment per cluster of products instead of per each product. ESMA wishes to highlight, however, that in order to comply with the

Level I and II requirements, which require a target market assessment for each product, the clustering approach should be such that it results in a similar outcome should the target market be assessed per product; in this context, sufficient granularity of the clusters is key, which requires considering multiple key factors when developing the clustering, as illustrated in paragraph 27 of the guidelines. ESMA therefore confirms the approach as proposed in guidelines 27 and 47.

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

75. Some respondents, including a consumer organisation agreed with the suggested approach on determination of the distribution strategy by the distributor.
76. Regarding paragraph 56, a few respondents, including the SMSG, welcomed the statement that products could still be sold to the client if firms do not have sufficient information to assess whether the client fits the target market, after warning the client that the firm is not in a position to assess the full compatibility of the client with the target market. A few other respondents, conversely, questioned the legal basis of such a warning, stating that providing it could be confusing for clients, and found it unclear what the content of such a warning would be.
77. Moreover, many respondents expressed concerns about the statement included under paragraph 56 that products should not be distributed under non-advised sales if the distributor cannot reasonably expect that the distribution strategy for the product will generally enable the product to reach the identified target market. They pointed to the limited information available based on the appropriateness assessment or the execution-only exemption. The SMSG, for example, noted that firms generally do not know the investor profile of clients under non-advised services, so they will not know whether the distribution strategy will enable the product to reach the identified target market. According to the SMSG, the suggested approach would result in effectively banning the sale of more complex and risky products via non-advised sales and thus unduly restrict the product offer for non-advised clients. The SMSG suggested ESMA to rephrase the sentence to clarify that the distribution strategy for more complex and risky products should be thoroughly checked, especially regarding actively marketed products (e.g., when using nudging and/or gamification techniques, influencers, as clarified in paragraph 59 of the guidelines). Other respondents suggested to delete the sentence or to limit it to retail clients and/or to active distribution strategies.
78. Regarding paragraph 59 of the guidelines, some respondents found it positive that ESMA stated that even more complex products could be distributed on a non-advised basis and agreed that non-advised sales coupled with certain specific marketing techniques may raise concerns. The focus, in their view, should be more on special sales such as gamification or active promotion of products, where the requirement to review such measures in the context of the distribution strategy makes perfect sense, as opposed to situations in which a client makes his or her own decisions and the firm is executing without

any active sales measures. The MSG noted that the term “behavioural finance” should be replaced by “nudging”, which would better capture the objective of such techniques.

79. Other respondents, however, expressed concerns about paragraph 59 of the guidelines. For example, they noted that the proposed measures would not be realistic for firms using mass communication tools, and a few feared that the suggested approach would result in the situation in which clients would have to ask for complex products because these would not be shown by firms anymore. A few noted that the term “more complex products” lacks clarity and indicated that for products for which no MiFID manufacturer exists, the distributor would have to make its own analysis. Firms manufacturing and/or distributing CFDs expressed the view that the proposed approach could be seen as a prohibition on the marketing of CFDs and could result in pushing the distribution of CFDs towards advised services. In their view, alternative measures exist, such as, using a compatibility questionnaire at the onset of the client relationship to assess whether the client falls within the target market of CFDs. Such a questionnaire would assess whether the client has the necessary knowledge and experience and understands that the majority of clients lose money and that the chances of profits are limited, whether his or her objectives would match the characteristics of CFDs (e.g., short-term speculative trading or hedging), whether the client would have the necessary risk tolerance, and whether he or she would be able to lose his or her entire invested capital.
80. ESMA notes the general support for its proposals on ensuring a compatible distribution strategy, in particular for more complex products distributed under non-advised services. ESMA wishes to reiterate that the requirement to identify additional measures in such cases, as included in paragraph 59 of the guidelines, would not amount to a prohibition on the distribution of more complex products under non-advised services. However, ESMA wishes to highlight that under the product governance requirements, also firms that distribute products under non-advised services should ensure that those products generally reach the identified target market for such products. This does not mean that such firms should, ex-ante, request information from each client regarding his or her compatibility with the five target market categories for products distributed under non-advised services, although firms may adopt such an approach if they deem this necessary. Also, it is reminded that, as already clarified in the guidelines, distributors should use any information and data deemed reasonably useful and reliable that may be available through other investment or ancillary services (if any is provided, e.g., investment advice). In addition, distributors could use any further information and data deemed reasonably useful that may be at their disposal and gathered through other sources. What should be required for firms distributing products under non-advised services, however, is to i) determine a compatible distribution strategy, including additional measures related to the marketing strategy and client’s choice environment where necessary, ii) to review whether the product is generally reaching the identified target market, and iii) to make adjustments to the distribution strategy for products that do not generally reach the identified target market.

**Q8: Do you agree with the suggested approach on the deviation possibility for diversification or hedging purposes when providing investment advice under a portfolio approach or portfolio management? In particular, do you agree that a deviation from the**

**target market categories “type of client” and “knowledge and experience” cannot be justified for diversification or hedging purposes, neither in the context of investment advice under a portfolio approach, nor portfolio management? Please also state the reasons for your answer.**

81. A few respondents, including a consumer organisation, agreed with the suggested approach. The MSG suggested to clarify in paragraph 64 that deviations are not only allowed for hedging or diversification purposes, but also in accordance with the procedures included in paragraph 84 and 85.
82. Some respondents, however, disagreed with the suggested approach. In their view, one of the advantages of the portfolio manager or investment advisor is to bridge the gap between the client’s knowledge and experience and the product. Therefore, deviations from all target market categories should be allowed when providing portfolio management and investment advice as long as the transactions would be suitable for the client. They noted that restricting the deviation possibility would be to the detriment of clients as it would prevent them from obtaining portfolio optimisation.
83. Many other respondents only agreed that deviations from the target market categories type of client and knowledge and experience should not be justifiable when providing investment advice to the client. According to them, for portfolio management, such restrictions should not apply. They pointed to the different nature of considering a client’s knowledge and experience when providing portfolio management. Such respondents noted that, although a client should understand the overall risks of the portfolio and have a general understanding of the risks linked to each type of product that can be included in the portfolio, the level of knowledge and experience needed by the client may be less detailed compared to investment advice. They also noted that the same would apply to the client type category.
84. A few respondents referred to the example of a hedge fund. They noted that although the target market for such a product should be limited to professional clients with a high level of knowledge and experience, a portfolio manager should nonetheless be able to buy it for diversification purposes on behalf of a retail client that does not possess the necessary knowledge and experience.
85. ESMA takes note of the concerns expressed by respondents. In relation to portfolio management, ESMA agrees that the nature of the assessment of a client’s knowledge and experience is different from investment advice, as the portfolio manager has the responsibility to take the investment decisions. Proposed footnote 33 was intended to convey this idea, in line with the approach included in ESMA’s guidelines on the MiFID II suitability requirements. In light of the input received, ESMA decided to elevate this footnote to the guidelines while making some clarifications. In relation to investment advice, however, ESMA confirms its position that deviations from the target market category “knowledge and experience” cannot be justified for diversification or hedging purposes. Different from a product’s diversifiable risk, other product’s features, for example, a product’s complex characteristics cannot be “diversified” when using a portfolio approach.



This is because, where an investment firm recommends a client to invest in a product for which he or she does not have sufficient knowledge and experience, the recommendation would not be suitable for the client, irrespective of whether the product is recommended as part of a portfolio approach. Likewise, ESMA considers that the deviations from the target market category “client type” cannot be justified for diversification or hedging purposes, irrespective of whether the firm provides investment advice or portfolio management. For completeness, ESMA notes that, apart from the portfolio approach for diversification or hedging purposes as a justification for deviations from the product’s target market, there might be other circumstances where sales outside the target market might be admissible, provided that all other legal requirements are met. This is already clarified in paragraph 84 of the Guidelines, where it is also emphasised that “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.”

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

86. A few respondents provided some general comments regarding product reviews. In particular, they noted some key aspects concerning the review process, as follows:

- the process of reviews should be compatible with automation when products are distributed to the mass retail market.
- it is important that the reviews are constructed in a way that they do not lead each time to a full readjustment of the categories, which would be disruptive.
- the interaction between the distributors and the manufacturers should be fluid.

87. More detailed comments were provided on paragraph 68, which provides clarifications on the criteria to be used by firms to review products. Many respondents supported the new paragraph introduced by ESMA, and in particular the proportionality principle embedded in the paragraph, allowing firms to determine the frequency and depth of product reviews. However, some comments were provided:

- A few respondents suggested ESMA to provide additional clarifications on the “qualitative and quantitative” criteria outlined in the paragraph and on what this requirement would entail in practice for firms.
- Others also noted that more flexibility should be left in the paragraph to manufacturers for assessing relevant criteria to be taken into account for reviewing products as, in some instances, the use of “both quantitative and qualitative” criteria could be overly burdensome, considering proportionality.
- In addition, more specification regarding “market events” was requested by a few respondents as it was noted that not every change in market conditions can be

considered as a crucial event and therefore proportionality would be needed in this respect.

- Lastly, a few respondents highlighted that the possibility offered to conduct less frequent reviews for simple products distributed under the execution-only regime should be extended to all situations where such products are distributed on a non-advised basis. The respondents noted that this requirement is not proportionate and might as an incentive for firms to distribute products under the execution-only regime, thus depriving clients from the protection afforded by the appropriateness regime.

88. ESMA has considered the comments provided and has decided to confirm paragraph 68. In this context, ESMA further reminds firms that all products manufactured or distributed should be subject to periodic reviews, irrespective of whether products are simpler or more complex.

89. The amendments to paragraph 70 introduce the clarification that firms have the responsibility to provide relevant information to manufacturers to support their reviews, and should not only do so at the manufacturer's request. Many respondents disagreed with the new requirements and provided comments in relation to this paragraph, as follows:

- Few respondents noted that this approach already exists, with the relevant information being provided by distributors at the request of the manufacturer. It was noted that ESMA's approach goes beyond the level 1 and would create a burdensome process for the distributors. Therefore, suggested ESMA to keep the previous approach and let distributors and manufacturers decide how they want to interact with each other.
- Some other respondents noted that the information to be provided by the distributor to the manufacturer should not be understood in an absolute manner that obliges distributors to generate information and automated feedback to all manufacturers without considering what information they need and how to collect. Respondents noted that this would otherwise create disproportionate obligations for distributors in view of the large number of financial instruments they distribute in the market.
- In this regard, a few respondents highlighted that the paragraph should aim at creating an effective way of receiving the relevant information instead of merely increasing the quantity of information exchanged, leading to a situation where distributors will have to report each individual sale to the manufacturer of a product, including in cases where the information has no meaningful value for the product review and there is no business relationship between it and the manufacturer.
- In this regard, it was noted that the exchange of feedback between the distributor and manufacturer should be structured, proportionate and limited to information which is of real relevance for producers. A few respondents indeed suggested that the obligation to report information to manufacturers should be limited to information on the incorrect definition of the target market, as well as its timeliness (with regard to information from distribution).

- Many respondents highlighted that the main responsibility should rest with the manufacturer, and it should be to the responsibilities of the manufacturers to collect relevant information to support their reviews.
- Lastly, a few comments were provided in relation to UCITS. It was noted that certain manufacturers of financial instruments (in particular, for example, UCITS) are not subject to MiFID II and, therefore, to the obligations of identification and review of the target market. In this framework, therefore, they may not request any information from their distributors about the target market or require it only partially within the framework of good practices. Considering the above, these respondents highlighted that the obligation for distributors to provide information on the target market must be understood only in response to an express request from the manufacturer ("to support the reviews of the manufacturers" when such reviews are carried out by the latter, especially when they are not obliged by MiFID II).

90. ESMA takes note of the comments received and confirms the approach outlined in the CP. Indeed, ESMA confirms, as outlined under paragraph 70, that distributors should proactively inform the manufacturer whenever they have relevant information that could support reviews by MiFID II manufacturers. This is to clarify that distributors have the responsibility to provide such relevant information to manufacturers and should not only do so at the manufacturer's request. ESMA reminds respondents that this clarification is intended to address the finding of the 2021 CSA that distributors often only passively provide such information to manufacturers, even if they have relevant information. Furthermore, ESMA is aware that certain entities manufacturing products may not be subject to MiFID II requirements. In this context, ESMA clarifies that paragraph 70 of the guidelines applies to MiFID II manufacturers.

91. Under paragraph 72, ESMA added a sentence in the CP regarding the responsibility for distributors to determine, on an ex-ante basis, what information they need to consider in assessing whether products generally reach the intended target market. ESMA also noted that firms may need to gather further information about their clients for this purpose, for example by asking additional questions to clients that have bought a product under non-advised services. Moreover, ESMA included that firms need to reconsider their distribution strategy for more complex products distributed through non-advised sales in some cases. While overall, respondents supported the paragraph especially in relation to more complex products, many comments were provided in relation to the use of client questionnaires:

- Many respondents, including the SMSG, advised ESMA to delete the example concerning the use of questionnaires to gather information from clients since this requirement goes beyond the Level I and II texts, would be very costly to implement, and would have a high probability of producing unreliable results.
- In this regard, a few respondents highlighted that the analysis of customer data should be performed in the context of testing whether the product was purchased by customers



outside the target market. They indeed highlighted that gathering additional information about the customer seems unrelated to the task at hand.

- Moreover, it was underlined by some respondents that sending questionnaires to a sample of clients in non-advised business may lead to an overload of interaction with the investor as investors who do not seek deliberately advice through online banks' channels intend precisely to avoid being overloaded with administrative burdens. Therefore, it was noted that such an approach that may be understood as an attempt to introduce a unique suitability distribution regime in all cases would not be desirable.
- Other respondents noted that distributors would normally have these data available with regards to their own distribution to clients without the need to recur to questionnaires. Furthermore, they noted that standardised data templates are available from FinDatEx (EFT template) to be used by distributors to share information with manufacturers concerning how products are distributed. In particular, they highlighted that investment firms have and are working towards the operationalisation of the product governance processes to increase quality of the process and the overall "value for money" for end investors and such a measure would therefore be disproportionate.
- Lastly, implications connected to the use of questionnaire and GDPR as well as EU and national marketing legislation were noted.

92. ESMA has carefully considered the above comments. ESMA has decided to remove the example of using a questionnaire to gather further information about their clients in paragraph 72. However, ESMA would like to stress that the general clarification that firms need sufficient information to perform product reviews still applies. It is up to firms to determine how they will gather this information and may choose to use a questionnaire. If sufficient client data is already available through other sources, firms can choose to use such data for their product reviews without using client questionnaires.

93. Under paragraph 73, ESMA provides guidance on the duration of the distributor's requirement to review products. Many respondents welcomed the requirement by which the distributor is no longer obliged to review the target market of a product that a distributor no longer offers, sells or recommends. In this regard, a few respondents required for this requirement to be extended to manufacturers.

94. However, many respondents disagreed with the requirement under paragraph 73 that a distributor should still be required to review the target market of a product that it recommends to its clients to hold but it is no longer offered. The following comments were provided on this specific point:

- It was suggested for ESMA to clarify that a product should not be subject to the review if a recommendation to hold the product occurs only from time to time and there should only be an obligation to review the product if the distributor regularly recommends holding that product.

- A few respondents noted that the function of the target market is to lead on ex-ante basis the products offer and requiring to assess the target market also for products that distributors recommend to hold is useless as the target market does not play any role with regard to products that can just be hold.
- Moreover, it was noted that distributors can advise the maintenance of a product already in a client's portfolio, even if not in the positive target market. This can be done to protect the customer, for example because costs of the products are not yet amortized.
- In addition to the above, a few respondents noted that the added value that this requirement will bring to consumers is unclear.
- Lastly, it should be noted that some respondents expressed their support to this additional requirement.

95. ESMA has carefully considered the above comments and decided to maintain the last sentence of paragraph 73 of the guidelines. ESMA wishes to stress that this necessarily follows from the fact that products should be reviewed as long as they are recommended (next to offered and sold), bearing in mind that every recommendation to a client to either buy, hold or sell product should be covered under the definition of making a recommendation on a product to a client. Nonetheless, ESMA added in paragraph 73 of the guidelines that the review obligation should be performed prior to making a recommendation, to clarify that, in case of a one-off recommendation, the review obligation would no longer apply after making that recommendation.

96. In addition to the above, some respondents focused on the new sustainability-related objectives requirements and asked ESMA to provide further guidance on how sustainability-related objectives should be covered by periodic review obligations. A few respondents also highlighted the fact that, with respect to the sustainability-related objective, a negative target market does not exist and therefore there is no possibility for the product to become unsuitable for the client.

97. Lastly, and as already outlined under paragraph 34, some respondents highlighted that certain aspects of the guidelines on periodic reviews are not applicable to some instruments such as bonds (and shares) in the secondary market. This issue is connected to the wider definition of manufacturers under MiFID which includes firms that qualify as manufacturers when advising corporate issuers on the launch of new products (Recital 15 of Delegated Directive 2017/593). Respondents noted that it seems difficult to extend review requirements to firms advising on corporate issues. In this regard, respondents advocate a proportionate approach regarding reviews in relation to investment firms which have been involved in a corporate issue in the past. Respondents noted that reviews by these firms could be more generic on the type of instruments for which they provide their services as accompanying investment firm. ESMA has taken note of these comments and refers to the response provided in paragraph 18 of this section.

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

98. The suggested approach was supported by many respondents. However, respondents suggested rephrasing paragraph 81 in order to provide better clarity, as the current wording is very long and may cause difficulties in interpretation in practice.
99. In particular, some respondents noted that clarity is needed on whether the exemption from defining the negative target market in relation to sustainability-related objectives applies to all products or only applies to products with sustainability features.
100. Some respondents asked to clarify in the guidelines the possibility for firms to offer instruments to clients that are neutral towards sustainability related objectives (e.g., sovereign bonds) or for which there is no data available.
101. ESMA has carefully considered the above comments and has redrafted paragraph 81 accordingly, in order to provide more clarity. In particular, paragraph 81 clarifies that for products which consider sustainability factors, firms are not required to identify a negative target market with respect to their sustainability-related objectives. However, ESMA reminds firms that a negative target market assessment should always be performed with respect to the five target market categories, but the sustainability-related objectives of these products should not be considered when performing such a negative target market assessment. Indeed, as clarified in Recital 7 of the MiFID II Delegated Directive, the rationale of this negative target market exemption is to ensure that products with sustainability factors remain easily available also for clients that do not have sustainability preferences.
102. Moreover, it was noted that ESMA should recognise that the sustainability features of a product may affect its risk/return profile and charging structure as the sustainability-related features of a product may contribute to said product being inappropriate for certain target markets. Therefore, sustainability factors could limit the target market for a product.
103. ESMA takes note of the comment and reminds firms of the requirement to perform a target market assessment for each product that is manufactured or distributed, using the five categories listed under paragraph 19 of the guidelines and also specifying any sustainability-related objective of the product in line with paragraph 20 of the guidelines. A negative target market assessment should also always be performed with respect to the five target market categories, except for the sustainability-related objectives of products which consider sustainability factors. Where target market aspects are not compatible with certain target market clients, for example, if the product with sustainability features concerns a risky product intended for clients with a long-term investment horizon and willing and able to lose their investment amount, this product would not be compatible with these target market clients (i.e., clients that would have a low risk tolerance in this example).
104. Lastly, a consumer organisation suggested ESMA to consider the introduction of the requirement for firms to specify, as part of the negative target market assessment, the

principle adverse impacts of the product as defined in the Sustainable Finance Disclosure Regulation (SFDR). It was noted that this would enable consumers to filter against “sustainable” products that have specific PAI (e.g., products heavily invested in fossil fuels).

105. ESMA takes note of the comment. However, ESMA confirms its decision not to be more prescriptive and granular at this stage with respect to sustainability. ESMA confirms it will monitor the practical implementation of the requirements by firms and the practical supervisory experience by competent authorities. Moreover, ESMA will continue liaising with the Commission on sustainability topics and on the broader sustainability framework.

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

106. All respondents that provided input to question 11 agreed with the suggested clarifications relating to the exemption where a product is marketed or distributed exclusively to eligible counterparties in paragraph 89.

107. However, some respondents expressed concerns about paragraph 94 and 95 on the target market identification in relation to professional clients. According to these respondents, the presumption that professional clients have the necessary knowledge and experience to understand the risks attached to particular products or services applies to both per se and elective professional clients. In their view, paragraphs 94 and 95 should thus be adjusted accordingly.

108. ESMA notes the broad support for the proposed amendments in paragraph 89. Regarding paragraph 94 and 95, ESMA would like to highlight that according to Annex II.1 of MiFID II, elected professional clients shall not be presumed to possess market knowledge and experience comparable to that of per se professional clients. According to ESMA, this difference in assumed knowledge and experience between elective and per se professional clients should be considered in the target market identification. Therefore, ESMA does not deem any amendments necessary to paragraphs 94 and 95.

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

109. Some respondents agreed with the list of good practices, for example indicating that it provides helpful guidance for firms on how to put appropriate processes into place. Other respondents, however, were more critical. Some of them expressed the view that the legal status of the good practices is unclear and that they should therefore be deleted. The MSG also pointed to the unclear legal effect, and requested ESMA to clarify several aspects, such as the purpose of the good practices (i.e., to clarify the guidelines or to nudge firms to behave in a certain way?). A few of those respondents noted their concern about the legal status of the good practices, and agreed that if the list were to be kept, it should only contain good practices. Conversely, a few respondents also requested ESMA to include bad practices.

110. ESMA takes the opportunity of the input received on this question to underline that the good practices set out in the annex are not part of the guidelines and are not subject to the “comply or explain process” by national competent authorities. While these practices are only illustrative examples, ESMA believes they are a useful way to provide firms with a benchmark and the additional comfort of knowing whether ESMA and national competent authorities encourage (good practices) particular instances of firms’ behaviour.

111. A few respondents provided input to the specific good practices (or even proposed additional good practices):

- First good practice (due diligence on distributors): the due diligence performed by the manufacturer on the distributor should only be high-level, as formal due diligence would add disproportionate complexity, and would require standardised templates to perform such due diligence.
- Third and fourth good practices (challenging decisions and engaging with the manufacturer): the term ‘challenging’ would imply a general mistrust vis-à-vis manufacturers and indicates that distributors should not be required to question the decisions by the manufacturer, or only to engage with the manufacturer where a distribution agreement is in place. In addition, distributors should not be required to define a narrower target market than the manufacturer.
- Fifth good practice (setting clear and detailed rules): should concern both manufacturers and distributors, distribution agreements are not required, and the choice of the relevant contractual form should be left to firms.
- Eighth good practice (blocking mechanisms): wording is excessive, unclear what the consequences of such blocking mechanisms are. It should be clarified that the firms still allow the client to trade under his/her own responsibility.
- Ninth and tenth good practices: unclear what improvements are expected from these good practices. Should be deleted or at least limited to active distribution, and other criteria should be added to the situation described.

112. ESMA takes note of the input received and has made several amendments to the good practices. At the same time, as explained above, ESMA highlights that the good practices do not constitute the only way in which firms can comply with the requirements. For instance, ESMA considers the example of firms adopting blocking mechanisms in their service as an adequate measure to avoid distribution of products outside of the target market, and NCAs have also seen firms adopting such measures in practice. However, other approaches may also be possible.

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

113. A few respondents, including a consumer organisation, considered the additional case study on options useful. However, the consumer organisation stressed that options are generally unsuitable for most retail clients and bring a disproportionately large risk of mis-selling; they should therefore not be actively distributed to retail clients and those wishing to access them on their own initiative should be warned of the danger.
114. Conversely, some respondents expressed the view that some of the aspects suggested by ESMA go beyond the level I requirements and can be understood as limiting the distribution of options. Examples are the need for a specific suitability assessment and the ratification or rejection by the client. A few respondents also noted that the scope should be clarified: in their view, the case study should not apply to exchange listed securities such as warrants and turbos because such products can never lead to contingent losses. Lastly, one respondent noted that a difference should be made between buying or writing options when opening or unwinding a position.
115. Regarding the case studies in general, some respondents questioned the legal status and stressed that the case studies should not form part of the guidelines. The SMSG, furthermore, asked whether the vocabulary used in the case studies should be seen as a kind of template.
116. Some respondents expressed concerns about the level of detail of some of the case studies, explaining that it would be impossible to match such granular target market categories with distributors' client profiles. The SMSG specifically referred to the knowledge and experience categories of the case studies 1 and 2, stating that with such level of detail, this section would include at least 10 to 15 categories.
117. ESMA takes note of the comments received and wishes to clarify that the case studies do not constitute additional requirements and they are not intended to be interpreted as templates. ESMA has included such case studies to illustrate how the requirements can be implemented in practice. However, the level of granularity used in the different case studies should convey ESMA's expectations as to the level of granularity that firms should adopt when performing the target market assessment.
118. In addition, some specific comments were received:
- The case studies on structured products do not mention annual coupon payments, which such products normally provide.
  - Case study 5 should be made consistent with the other case studies.
  - The six-year horizon should be seen as a long-term and not as a medium-term horizon.
119. Lastly, some respondents requested ESMA to include a case study on a product that considers sustainability factors, and on how to cluster similar products based on sustainability factors. One respondent requested ESMA to include a case study on complex UCITS.



120. ESMA agrees that including a case study on a product that considers sustainability factors would be useful at some stage but considers it premature at this stage as firms' approaches still have to develop.

#### **Other comments received**

121. The SMSG also provided input to paragraphs 70, 78 and 86 of the guidelines, for which ESMA did not propose any changes in the Consultation Paper.

122. The SMSG advised ESMA to change paragraph 70. The SMSG noted that a large number of manufacturers is not subject to MiFID II, including issuers of simple bonds and shares, investment funds, and third country manufacturers. If the distributor is not able or willing to devote the resources necessary to determine a target market for those products, or if the distributor cannot obtain sufficient information from the product provider and there is insufficient publicly available information available to identify the target market with sufficient granularity or certainty, the distributor is not allowed to include the product in its product assortment. The effect is, however, that European investors' access to foreign products is excessively reduced.

123. The SMSG suggested that ESMA implements a two-step solution. First, if manufacturers do not provide target market information due to the fact that they are not subject to MiFID II, distributors could use the clustering referred to in paragraph 47 of the draft guidelines as an instrument to efficiently define target markets for certain products. Plain vanilla shares/bonds could for instance be grouped into one cluster. Second, where the distributor does not possess sufficient information to identify the target market for a given product, this product should not be actively marketed or promoted, directly nor indirectly (e.g., through affiliated parties). However, clients who would like to invest in such products on an execution-only / non-advised basis should not be prohibited from doing so. Product distributors should be allowed to exceptionally sell the product to clients who ask for such a product on their own initiative, subject to a clear warning that the product distributor has not been able to determine whether the client fits the target market for this product (in the same vein as under the circumstances of paragraph 56 of the draft guidelines). While investors who are not aware of the existence of such products would in such circumstances remain unaware and thus not acquire it, more active investors who would want to invest in such products in an execution only / non-advised environment, would not be prohibited from doing so. In the SMSG's opinion, distributors should indeed be able to act as intermediaries for products which they do not actively promote to their clients, but which a client would want to invest in on an execution only / non-advised basis, on its own initiative and its own responsibility, even without the distributor having defined a target market for such products.

124. Regarding paragraph 78 of the guidelines, the SMSG recommended ESMA to clarify what it is meant by "reviewing it with a critical look".

125. The SMSG identified a few issues with paragraph 86 of the guidelines: it would be inherently contradictory, it would have become redundant with paragraph 56 of the guidelines, and, most fundamentally, it would lead to the concern that a strict interpretation

of the product governance guidelines could overly restrict the available product range, especially for non-advised clients. It sees a real danger that firms, fearing liability claims or sanctions from the supervisor, would become too prudent and overly restrict their product range. The result would be that often only clients with a private banking profile would get access to products with a higher risk and a corresponding potential higher return. This way, other clients would be deprived of diversification possibilities. According to the SMSG, the situation in which firms can, on their own initiative, deny large categories of clients access to a much wider range of product seems very far-reaching.

126. The SMSG noted that this effect could be avoided with the following approach in paragraph 86 of the guidelines: firms should never actively market or offer a product to a client who falls outside the target market for that product, but if a non-advised client nevertheless wants to invest in such a product, he or she should be able to do so at his or her own initiative and responsibility, subject to the motivation and reporting duties applicable to sales to clients outside the target market or in the negative target market. With this approach, the majority of retail investors will typically remain unaware of the existence of products for which they fall outside the target market (no marketing), and will thus not acquire it, but more active investors who would want to invest in such products and are willing to bear the related risks, would not be frustrated.

127. ESMA appreciates the comments received. However, it also notes that the risk of an excessively restricted product offer due to the product governance requirements has not been observed by NCAs when performing the 2021 CSA on product governance. ESMA considers that the risk would rather be the other way around, i.e., firms distributing more complex products to the mass retail market, involving a significant risk that such products are distributed to clients falling outside of the target market. As to the specific proposal in relation to paragraph 70 of the guidelines, ESMA deems that this would not be in line with the Level II requirements as these do not provide for such exemptions; firms should identify the target market for each product, except for bonds with make whole clauses and products exclusively distributed to eligible counterparties. The proposal in relation to paragraph 86, in a way, would be line with ESMA's approach under paragraph 59 of the guidelines; as an example of a measure to ensure that a compatible distribution strategy has been determined for a more complex product, a firm could decide to not distribute it actively but only on the client's initiative. However, also in such cases, firms should ensure that sales outside the target market are not the rule, and they should periodically review whether the distribution strategy remains compatible.



## 3.5 Annex V - Guidelines

### 1. Scope

#### Who?

1. These guidelines apply to:

- Firms.
- Competent authorities.

#### What?

2. These guidelines apply in relation to the manufacturing or distribution of financial instruments and structured deposits. In particular, these guidelines apply in relation to the following requirements:

- i. Article 9(3) of Directive 2014/65/EU<sup>16</sup> (MiFID II);
- ii. Article 16(3) and 16(6) of MiFID II;
- iii. Article 24(1) and 24(2) of MiFID II;
- iv. Articles 9 and 10 of the Commission Delegated Directive (EU) 2017/593<sup>17</sup> (MiFID II Delegated Directive).

#### When?

3. These guidelines apply as from two months from the date of publication of the guidelines on ESMA's website in all EU official languages.

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<sup>16</sup> Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (OJ L 173, 12.06.2014, p. 349).

<sup>17</sup> Commission Delegated Directive (EU) 2017/593 of 7 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits (OJ L 87, 31.3.2017, p. 500-517).

## 2. Legislative references, abbreviations and definitions

### 2.1 Legislative references

ESMA Regulation		Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC <sup>18</sup>
MiFID II		Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU <sup>19</sup>
MiFID II regulation	Delegated	Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive <sup>20</sup>
Commission Regulation 2021/1253	Delegated (EU)	Commission Delegated Regulation (EU) 2021/1253 of 21 April 2021 amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms <sup>21</sup>

### 2.2 Abbreviations

ACP	Advisory Committee on Proportionality
CP	Consultation Paper
CSA	Common Supervisory Action
EC	European Commission
EEA	European Economic Area

<sup>18</sup> OJ L 331, 15.12.2010, p. 84.

<sup>19</sup> OJ L 173, 12.06.2014, p. 349

<sup>20</sup> OJ L 87, 31.3.2017, p. 1.

<sup>21</sup> OJ L 277, 2.8.2021, p. 1.

ESFS	European System of Financial Supervision
ESMA	European Securities and Markets Authority
EU	European Union
SMSG	Securities and Markets Stakeholder Group

## 2.3 Definitions

firms	investment firms (as defined in Article 4(1)(1) of MiFID II) and credit institutions (as defined in Article 4(1)(27) of MiFID II) when providing investment services and activities (as defined in Article 4(1)(2) of MiFID II), investment firms and credit institutions when selling or advising clients in relation to structured deposits, UCITS management companies (as defined in Article 2(1)(b) of UCITS Directive <sup>22</sup> ) and external Alternative Investment Fund Managers (AIFMs) (as defined in Article 5(1)(a) of the AIFMD <sup>23</sup> ) when providing the investment services of individual portfolio management or non-core services (within the meaning of Article 6(3)(a) and (b) of the UCITS Directive and Article 6(4)(a) and (b) of the AIFMD), in each case excluding where financial instruments are marketed or distributed exclusively to eligible counterparties (in accordance with the exemption in Article 16a of MiFID II)
products	financial instruments (within the meaning of Article 4(1)(15) of MiFID II), excluding bonds with no other embedded derivative than a make-whole clause in accordance with the exemption in Article 16a of MiFID II, and structured deposits (within the meaning of Article 4(1)(43) of MiFID II)
manufacturer	a firm that manufactures a product, including the creation, development, issuance or design of that product, including when advising corporate issuers on the launch of a new product;

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<sup>22</sup> Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (OJ L 302, 17.11.2009, p. 32)

<sup>23</sup> Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 (OJ L 174, 01.07.2011, p.1-73).

distributor

a firm that offers, recommends or sells a product and service to a client.

### **3. Purpose**

4. These guidelines are based on Article 16(1) of the ESMA Regulation. The objectives of these guidelines are to establish consistent, efficient and effective supervisory practices within the ESFS and to ensure the common, uniform and consistent application of the MiFID II requirements on product governance. In complying with these guidelines, ESMA anticipates a corresponding strengthening of investor protection.

## **4. Compliance and reporting obligations**

### **4.1 Status of the guidelines**

5. In accordance with Article 16(3) of the ESMA Regulation, competent authorities and financial market participants must make every effort to comply with these guidelines.
6. Competent authorities to which these guidelines apply should comply by incorporating them into their national legal and/or supervisory frameworks as appropriate, including where particular guidelines are directed primarily at financial market participants. In this case, competent authorities should ensure through their supervision that financial market participants comply with the guidelines.

### **4.2 Reporting requirements**

7. Within two months of the date of publication of the guidelines on ESMA's website in all EU official languages, competent authorities to which these guidelines apply must notify ESMA whether they (i) comply, (ii) do not comply, but intend to comply, or (iii) do not comply and do not intend to comply with the guidelines.
8. In case of non-compliance, competent authorities must also notify ESMA within two months of the date of publication of the guidelines on ESMA's website in all EU official languages of their reasons for not complying with the guidelines.
9. A template for notifications is available on ESMA's website. Once the template has been filled in, it shall be transmitted to ESMA.
10. Financial market participants are not required to report whether they comply with these guidelines.



## 5. Guidelines on the application of Articles 16(3) and (6) and 24(2) of MIFID II

### 5.1 General

11. These guidelines should, in accordance with subparagraph 2 of Article 9(1), and subparagraph 1 of Article 10(1) of the MiFID II Delegated Directive, be applied in a way that is appropriate and proportionate, taking into account the nature of the product, the investment service and the target market of the product.
12. When a firm acts both as the manufacturer and distributor of products, the guidelines set out below apply as relevant, and as long as the firm meets all the applicable manufacturer and distributor obligations.
13. In general, firms acting as manufacturers and/or distributors should substantiate and document choices made in the context of their product governance arrangements, including with regard to the target market identification and related distribution strategies.

### 5.2 Guidelines for manufacturers

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

14. The potential target market identification by manufacturers should not solely be conducted on the basis of quantitative criteria but needs to be based on sufficient qualitative considerations as well. In identifying the target market for a product, manufacturers should also take into account the results of the scenario and charging structure analyses<sup>24</sup> undertaken for the relevant product<sup>25</sup>. Services for the mass market in particular, may require automation of processes and this automation is usually based on formulas or algorithmic methodologies that process quantitative criteria for products and clients. Such numerical data is usually generated through scoring systems (for example, by using product features like volatility of financial instruments, ratings of issuers, etc. or through “conversion” of factual data into numerical systems). With regard to the target market identification, firms should not exclusively rely on such quantitative criteria but sufficiently balance them with qualitative considerations.
15. Manufacturers should use the list of categories set out in these guidelines as a basis for identifying the target market for their products. The list of the categories is cumulative: when assessing the target market, each manufacturer should use each of those categories.

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<sup>24</sup> The terms “scenario” analyses and “charging structure” refer to the analyses required under respectively Article 9(10) and (12) of the MiFID II Delegated Directive.

<sup>25</sup> For example, the scenario analyses performed by the firm may reveal that a product’s value is particularly sensitive to negative market conditions, leading to the identification of a narrower target market in terms of clients’ risk tolerance. As another example, the charging structure analysis performed by the firm may reveal that the charging structure of the product is not compatible with the identified target market, leading the firm to modify the charging structure of the product and/or reassess the target market. ESMA provided guidance on the application of the charging structure analysis requirement in Q&A 16.2-4 of its Questions and Answers on MiFID II and MiFIR investor protection and intermediaries topics ([https://www.esma.europa.eu/sites/default/files/library/esma35-43-349\\_mifid\\_ii\\_qas\\_on\\_investor\\_protection\\_topics.pdf](https://www.esma.europa.eu/sites/default/files/library/esma35-43-349_mifid_ii_qas_on_investor_protection_topics.pdf)).

In doing so, a manufacturer should analyse the relevance of each category for a certain product and then align the depth of the identification in proportion to the type, nature and other features of the product (as described in paragraph 19-31 of the guidelines).

16. Manufacturers should detail/describe each of these categories, without merging categories, while taking into account their relationship and ensuring the consistency between different categories since they all contribute to the definition of the target market for a given product.
17. Manufacturers should not exclude any of the five below mentioned categories. If, in the manufacturers' view, these five categories are too restrictive to identify a meaningful target market, additional categories may be added. In the decision, whether to use such additional categories or not, manufacturers may take into account the characteristics of the information-channels with distributors. For example, in order to facilitate the exchange of information with distributors and to foster open architecture, manufacturers may limit the use of additional categories to cases where these are essential to define a meaningful target market for the product.
18. Manufacturers need to identify a potential target market<sup>26</sup>. As they usually do not have direct client contact, and in accordance with subparagraph 2 of Article 9(9) of the MiFID II Delegated Directive, this means that their target market identification may be based inter alia on their theoretical knowledge and experience of the product.
19. Manufacturers should use the following list of five categories:
  - a) The type of clients to whom the product is targeted: The firm should specify to which type of client the product is targeted. This specification should be made according to the MiFID II client categorisation of "retail client", "professional client" and/or "eligible counterparty". To avoid possible misuse of the exemption provided in Article 16a MiFID II<sup>27</sup>, the decision to market or distribute a product exclusively to eligible counterparties should clearly be made ex ante (either when performing the initial target market assessment or when performing periodic reviews), based on the firm's internal processes.
  - b) Knowledge and experience: The firm should specify the knowledge that the target clients should have about elements such as: the relevant product type, product features and/or knowledge in thematically related areas that help to understand the product. For example, for structured products with complicated return profiles, firms could specify that target investors should have knowledge of how this type of product works and the likely outcomes from the product. Regarding experience, the firm could describe how much practical experience target clients should have with elements such as: relevant product type, relevant product features and/or experience in thematically related areas. The firm could specify, for example, a time period for which clients should have been

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<sup>26</sup> See Article 9(9) of the MiFID Delegated Directive.

<sup>27</sup> According to Article 16a of MiFID II, a firm is, inter alia, exempted from the product governance requirements where the financial instruments are marketed or distributed exclusively to eligible counterparties.

active in the financial markets. Knowledge and experience may be dependent on each other in some cases (i.e., an investor with limited or no experience could be a valid target client if they compensate missing experience with extensive knowledge).

- c) Financial situation with a focus on the ability to bear losses: The firm should specify the percentage of losses target clients should be able and willing to afford (for example, from minor losses to total loss) and if there are any additional payment obligations that might exceed the amount invested (for example, margin calls). This could also be phrased as a maximum proportion of assets that should be invested.
- d) Risk tolerance and compatibility of the risk/reward profile of the product with the target market: The firm should specify the general attitude that target clients should have in relation to the risks of investment. Basic risk-attitudes should be categorised (for example, “risk oriented or speculative”, “balanced”, “conservative”) and clearly described. Since different firms in the chain may have different approaches to defining risk, the firm should be explicit about the criteria that must be met in order to categorise a client in this way. Firms should use the risk indicator stipulated by the PRIIPs Regulation<sup>28</sup> or the UCITS Directive, where applicable, to fulfil this requirement. Where relevant, firms should also consider the risks included in the narrative below the PRIIPs summary risk indicator, such as currency and/or liquidity risk.
- e) Clients’ Objectives and Needs: The firm should specify the investment objectives and needs of target clients that a product is compatible with, including the wider financial goals of target clients or the overall strategy they follow when investing. Those objectives can be “fine-tuned” by specifying particular aspects of the investment and expectations of targeted clients. The particular clients’ objectives and needs a product is intended to fulfil may vary from specific to more generic. For example, a product may be designed to meet the needs of a specific age demographic, to achieve tax efficiency based on clients’ country of tax residence, or be designed with special product features to achieve specific investment objectives such as “currency protection”, “regular payments”, etc., as relevant. In addition, reference should be made to the expected investment horizon/recommended holding period (e.g., number of years the investment is to be held), duly considering the potential impacts for clients of an early exit (for example in terms of costs).

20. Within the broad category of clients’ objectives and needs, the firm should also specify any sustainability-related objectives the product is compatible with. To ensure a sufficient level of granularity of the target market, when identifying sustainability-related objectives, firms

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<sup>28</sup> Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs) (OJ 352, 09.12.2014, p. 1–23).

may specify, where relevant, the following aspects (in line with the definition of “sustainability preferences” according to Article 2(7) of the MiFID II Delegated Regulation<sup>29</sup> and as further detailed in the ESMA guidelines on certain aspects of the MiFID II suitability requirements):

- a) The minimum proportion of the product that is invested in environmentally sustainable investments as defined in Article 2, point (1), of Regulation (EU) 2020/852<sup>30</sup>;
- b) The minimum proportion of the product that is invested in sustainable investments as defined in Article 2, point (17), of Regulation (EU) 2019/2088<sup>31,32</sup>;
- c) Which principal adverse impacts (PAI) on sustainability factors are considered by the product, including quantitative or qualitative criteria demonstrating that consideration. Firms could use the categories presented in the SFDR RTS<sup>33</sup> (instead of an approach based on each PAI indicator) such as “emissions”, “energy performance”, “water & waste”, etc.
- d) Whether, where relevant, the product has a focus on either environmental, social or governance criteria or a combination of them<sup>34</sup>;

21. Depending on the characteristics of the specific product manufactured, the description of one or more of the above categories may result in the identification of a broad group of target clients that could also encompass a more restricted group. For example, if a product is considered compatible with target clients possessing general relevant knowledge and experience, obviously it will be compatible with a sophisticated level of knowledge and experience.

22. In order to avoid the risk of misinterpretations and misunderstandings, manufacturers should clearly define the concepts and terminology used when defining the target market across the five categories listed in paragraph 19 above.

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

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<sup>29</sup> Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (OJ L 87, 31.3.2017, p. 1).

<sup>30</sup> Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 (OJ L 198, 22.6.2020, p. 13).

<sup>31</sup> Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (OJ L 317, 9.12.2019, p. 1).

<sup>32</sup> The product’s minimum proportion referred in the two bullet points above is the one published in the product’s binding contractual documentation such as the one referred to in Article 6 of Regulation (EU) 2019/2088 or any other relevant legal document.

<sup>33</sup> Commission Delegated Regulation (EU) 2022/1288 of 6 April 2022 supplementing Regulation (EU) 2019/2088 of the European Parliament and of the Council with regard to regulatory technical standards specifying the details of the content and presentation of the information in relation to the principle of ‘do no significant harm’, specifying the content, methodologies and presentation of information in relation to sustainability indicators and adverse sustainability impacts, and the content and presentation of the information in relation to the promotion of environmental or social characteristics and sustainable investment objectives in pre-contractual documents, on websites and in periodic reports (OJ L 196, 25.7.2022, p. 1–72)

<sup>34</sup> As referred to in paragraph 27, second bullet point, of the ESMA Guidelines on certain aspects of the MiFID II suitability requirements (Ref. ESMA35-43-3172).

23. The identification of the potential target market should be done for all products, in an appropriate and proportionate manner, considering the nature of the product. This means that the target market identification should consider the characteristics of the product including its complexity (including costs and charges structure), risk-reward profile or liquidity, or its innovative character.
24. In this context, manufacturers should define and adequately graduate the level of complexity to be attributed to manufactured products to determine the necessary level of detail with which the target market should be identified. Although complexity is a relative term, which depends on several factors, firms should also take into account, the criteria and principles identified in Article 25(4) of MiFID II.
25. For more complex products, such as structured products with complicated return profiles, the target market should be identified with more detail. For simpler, more common products it is likely that the target market will be identified with less detail<sup>35</sup>. Depending on the product, the description of one or more of the above-mentioned categories may be more generic. The simpler a product is, the less detailed a category may be.
26. For certain particularly complex and risky products, such as contracts for difference (CFDs) and other products with similar features, manufacturers should perform a very careful target market assessment, resulting in a significantly reduced target market or no compatible target market at all. If a manufacturer considers that a CFD or product with similar characteristics does not have a compatible target market, it should not make the product available for distribution. If a manufacturer considers that there is a target market whose needs, characteristics and objectives a CFD, or a product with similar features, is compatible with, such a target market should in any case be confined to high-risk seeking clients understanding the risks involved and who are able and prepared to lose money, on average, with their investment and who are seeking speculative investments with only a small chance of earning positive returns.
27. Manufacturers may also decide to define the target market by adopting a common approach for some products if they have sufficiently comparable product features (“clustering approach”). When adopting a clustering approach, manufacturers should use a sufficient level of granularity to ensure that only products with sufficiently comparable characteristics and risk features are grouped together (i.e., clusters should be homogeneous in themselves and heterogeneous towards other clusters). In ensuring that homogenous clusters are identified, firms should pay particular attention to the level of complexity of products, meaning that the more complex the underlying products of a cluster become, the more granular the clustering should be. Generally speaking, for certain more complex products, it is expected that a clustering approach will not be appropriate and that firms should define the target market at the level of the individual product.
28. Manufacturers should consider multiple key factors when clustering products, such as: risk factors (such as market, credit and liquidity risk); charging structure (level and type of

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<sup>35</sup> See Recital 19 of the MiFID II Delegated Directive.

costs); optionality elements (in case of derivatives, or products with embedded derivatives); financial leverage; eligibility to bail-in; subordination clauses; observability of the underlying (e.g. the use of unfamiliar or opaque indices); guarantees of principal repayment or capital protection clauses; liquidity of the product (i.e. tradability on trading venues, bid-ask spread, selling restrictions, exit charges); and the currency denomination of the product).

29. When using a clustering approach, the manufacturer should always check and document for each specific product whether it belongs to a certain cluster and thus whether the target market identified for this cluster can be assigned to this product. For this purpose, clear criteria should be specified under each cluster. In any case, when using a clustering approach, manufacturers should consider the outcomes of the charging structure and scenario analyses of each product.
30. In all cases, including when using a clustering approach, the target market must be identified at a sufficiently granular level to avoid the inclusion of any groups of investors for whose needs, characteristics and objectives the product is not compatible.
31. For bespoke or tailor-made products, the target market of the product will usually be the client who ordered the product unless the distribution of the product to other clients is also foreseen.

#### **Articulation between the distribution strategy of the manufacturer and its definition of the target market**

32. According to Article 16(3) of MiFID II, the manufacturer shall ensure that its intended distribution strategy is consistent with the identified target market and, according to Article 24(2) of MiFID II, the manufacturer needs to take reasonable steps to ensure that the product is distributed to the identified target market. The manufacturer should define its distribution strategy so that this strategy favours the sale of each product to the target market of this product. This includes that, when the manufacturer can choose the distributors of its products, the manufacturer makes its best efforts to select distributors whose type of clients and services offered are compatible with the target market of the product.
33. In defining the distribution strategy, a manufacturer should determine the extent of clients' information necessary to the distributor to properly assess the target market for its product. Hence, the manufacturer should propose the type of investment service through which the targeted clients should or could acquire the financial instrument. If the product is deemed appropriate for a sale without advice, the firm could also specify the preferred acquisition channel.

### **5.3 Guidelines for distributors**

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



34. The distributor's target market identification (i.e., the identification of the 'actual' target market for that product) should be conducted as part of the general decision-making process about the range of services and products the distributor is going to distribute. Hence, the actual target market identification should occur at an early stage on an ex-ante basis (i.e., before going into daily business and/or before deciding whether the product should be included in the firm's offer), based on the firm's business policies and distribution strategies as defined by the management body. In particular, the identification of the target market of products intended for distribution should ensure that the decisions undertaken to define the distributor's product assortment are based on the consideration of the characteristics, objectives and needs of the distributor's client base.
35. In particular, distributors should take responsibility to ensure, from the very beginning, the general consistency of the products and investment and/or ancillary services that are going to be offered, and to choose which products are to be offered under the different services, to ensure compatibility with the needs, characteristics, and objectives of target clients. The aspects related to this general consistency of products, services and distribution strategies with target clients should be addressed and formalised in the firm's policy as to the services, activities, products and operations offered or provided.<sup>36</sup>
36. The decision-making process about the service and product universe in combination with the target market identification process should directly influence the way in which the firm's daily business is conducted, as the management body's choices are implemented along the firm's decision chain and hierarchy. Those processes will jointly have a direct impact on the compatibility of products and services offered and will influence all other relevant processes connected with the services provided, especially the definition of budgeting objectives and staff remuneration policies.
37. Firms should especially focus on the investment services through which the products will be offered to their respective target markets. In this context, ESMA expects that the nature of the products is duly taken into account, paying particular attention to those products characterised by complexity/risk features or by other relevant features (such as, for example, illiquidity and innovation).<sup>37</sup> For example, if a distributor has detailed information on some clients (for example, through an existing relationship with them for the provision of investment advice), it could decide that, considering the particular risk-reward profile of a product, the interest of this group of clients would be best served if execution services are excluded for them. Similarly, the distributor could decide that some non-complex products which could potentially be offered under the execution-only regime will only be

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<sup>36</sup> In line with Article 9(3)(b) of MiFID II.

<sup>37</sup> This is in line with Recital 18 of the MiFID II Delegated Directive, which clarifies: 'in light of the requirements set out in Directive 2014/65/EU and in the interest of investor protection, product governance rules should apply to all products sold on primary and secondary markets, irrespective of the type of product or service provided and of the requirements applicable at point of sale. However, those rules may be applied in a proportionate manner, depending on the complexity of the product and the degree to which publicly available information can be obtained, taking into account the nature of the instrument, the investment service and the target market. Proportionality means that these rules could be relatively simple for certain simple, products distributed on an execution-only basis where such products would be compatible with the needs and characteristics of the mass retail market'.

offered in accordance with appropriateness or suitability requirements, so as to grant a higher degree of protection to clients.

38. Specifically, distributors should decide which products are going to be recommended (also through the provision of portfolio management) or offered or actively marketed to certain groups of clients (characterised by common features in terms of knowledge, experience, financial situation, etc.). Distributors should also decide which products will be made available to (existing or prospective) clients at their own initiative through execution services without active marketing, considering that in such situations the level of client information available may be very limited.
39. At the same general decision-making stages, distributors should consider what distribution strategies should be used for the different client groups, including the way in which products will be marketed. In particular, where firms intend to use nudging and digital engagement practices such as gamification techniques<sup>38</sup> for the distribution of certain products, distributors should carefully assess whether using such techniques would be in the best interests of the client group for which such strategies would be used. Distributors should therefore determine to which groups of clients such services will be made available, based on the characteristics of the clients or potential clients. However, certain gamification techniques (such as those used in trading apps designed to nudge the (potential) client towards harmful behaviour, e.g., maximise the number of trades) will never be in the interest of the client. Additionally, nudging and digital engagement practices can contribute to the distribution of products outside of their target market. When determining the target market for their services, distributors should also pay particular attention to situations in which a bundle of services will be provided to clients, such as both execution services and the ancillary service of granting loans allowing the client to carry out the transaction.
40. In any case, where on the basis of all information and data that may be at the distributors' disposal and gathered through investment or ancillary services or through other sources, including the information obtained from manufacturers, the distributor assesses that a certain product will never be compatible with the needs and characteristics of its existing or prospective clients, it should not include the product in its product assortment (i.e. the products that will be offered, to whom, and through the provision of which investment services).

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

41. The obligation of the distributor to identify the actual target market and to ensure that a product is distributed in accordance with the actual target market is not substituted by an assessment of suitability or appropriateness and has to be conducted in addition to, and

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<sup>38</sup> Gamification techniques add games or game-like competitive elements to non-game contexts such as financial services. Examples of game-like elements are earning of points or badges; keeping score or leader boards; showing performance graphs; by using meaningful stories or avatars to engage users; or introducing teammates to either induce conflict, cooperation, or competition. Gamification is a type of digital engagement practice that can be used; in turn, digital engagement practices refer to how actively users interact with a software application or platform.

before such an assessment. In particular, the identification, for a given product, of its target market and related distribution strategy should ensure that the product ends up with the type of customers for whose needs, characteristics and objectives it had been designed, instead of with another group of clients for whom the product may not be compatible.

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

42. Distributors should use the same list of categories used by manufacturers (see paragraph 19 and 20) as a basis for defining the target market for their products, also avoiding merging two or more categories (see paragraph 16). However, distributors should define the target market on a more concrete level and should take into account the type of clients they provide investment services to, the nature of the products and the type of investment services they provide and the level of detail of information gathered from clients. In this context, distributors should ensure that the concepts used for the definition of the actual target markets for products are aligned with the concepts used in the context of the suitability and appropriateness arrangements. For example, regarding the manufacturer's target market category of knowledge and experience, which may broadly refer to "basic", "average" or "advanced" investors, the distributor should adopt a more granular classification consistent with its suitability or appropriateness arrangements, where appropriate given the features of the products; another example would be a distributor that, in relation to the category clients' risk tolerance, specifies clients' willingness to take the risk of a decline in the product's value by a certain percentage. Importantly, when defining the actual target market for products, distributors should use consistent terms and definitions and should ensure consistency between the actual target markets defined for products with homogeneous product features.
43. Since the manufacturer has to specify the potential target market based on its theoretical knowledge and experience with a similar product, it will determine the product's target market without specific knowledge of individual clients. Therefore, the manufacturer's assessment will be conducted with a more general view of how the features/nature of a product would be compatible for certain types of investors, based on their knowledge of the financial markets and their past experience with similar products. In this way, a set of boundaries is introduced on a more abstract level.
44. The distributor on the other hand has to specify the actual target market, considering the boundaries of the potential target market set by the manufacturer. Distributors should base their target market on their information and knowledge of their own client base and the information received from the manufacturer (if any) or information that has been obtained by the distributor itself via desk research (especially in cases where the distributor is a new firm that does not yet have enough-actual information about its own clients). Distributors should use the manufacturer's more general target market assessment together with existing information on their clients or prospective clients to identify their own target market for a product that is the group of clients to whom they are effectively going to offer the product through the provision of their services.

45. To this end, distributors should conduct a thorough analysis of the characteristics of their client base, i.e., existing clients, as well as prospective clients (for example, a distributor may have clients with bank deposits to whom they intend to offer investment services). Distributors should use any information and data deemed reasonably useful and available for this purpose that may be at the distributors' disposal and gathered through investment or ancillary services. In addition, they could use any information and data deemed reasonably useful and available that may be at the distributors' disposal and gathered through sources other than the provision of investment or ancillary services.
46. When refining the manufacturer's target market, the distributor should not deviate from the fundamental decisions made therein. However, distributors cannot just rely on the manufacturer's target market without considering how the target market defined by the manufacturer would fit to their client base. For that purpose, distributors should implement and maintain a dedicated process, which needs to be run in all cases. This process is subject to proportionality, i.e., the scrutiny and – if necessary – the refinement of the manufacturer's target market by the distributor should be more intensive for more complex products and could be less intensive in case of simpler, more common products. To ensure a proper scrutiny of such more complex products, distributors should also determine whether, next to the manufacturer's target market description, they need access to underlying assessments such as the outcomes of the manufacturer's scenario and charging structure analyses. If, as a result of the process, the distributor comes to the conclusion that the target market of the manufacturer does not need to be refined, the distributor may use the manufacturer's target market as it is.
47. Distributors may also decide to define the target market by adopting a clustering approach for some products, in line with the principles of ensuring a sufficient level of granularity as indicated in paragraphs 27-30. For example, in ensuring that only UCITS with sufficiently comparable characteristics are clustered for the purposes of the target market identification, differentiating factors would be the types of asset classes the UCITS invests in, its investment strategy, risks, charging structure (e.g., level and types of costs), any leverage used, and so on. Such factors should be used in a cumulative manner.
48. Usually, the target market assessment of the distributor will occur after the manufacturer has communicated its target market to them. However, it is possible that manufacturer and distributor could define both the manufacturer's target market and the distributor's target market, including any review and refinement process, at the same time. This could, for example, occur where the manufacturer and the distributor jointly develop a common target market standard for the products they usually exchange. Both the manufacturer and the distributor retain their responsibility for their obligations to identify a target market as described in MiFID II and the MiFID II Delegated Directive and further specified in these guidelines to identify a target market. A manufacturer has still to take reasonable steps to ensure that products are distributed to the identified target market and a distributor has to ensure that products are offered or recommended only when this is in the interest of clients.
49. When distributors define their product assortment, they should pay particular attention to situations where they might not be able to make a thorough target market assessment by

virtue of the type of services they provide (in particular, execution services under the appropriateness test or the execution-only regime). This is especially important for products characterised by complexity/risk features (or other relevant features such as, for example, illiquidity or innovation), as well as for situations where there might be significant conflicts of interest (such as in relation to products issued by the firm itself or by other entities within the group). In such circumstances, it is most important that distributors take into due consideration all relevant information provided by the product manufacturer, both in terms of target market and distribution strategy.

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

50. The identification of the target market assessment by the distributor should also be done in an appropriate and proportionate manner, considering the nature of the product, in line with what described in paragraph 23 to 31.
51. Where the manufacturer has identified a target market for simpler, more common products the distributor's target market identification does not necessarily have to result in a refinement of the manufacturer's target market.

#### **Identification and assessment of the target market by the distributor: interaction with investment services**

52. As noted above, distributors are required to identify and assess the circumstances and needs of the group of clients to whom they are effectively going to offer or recommend a product, so as to ensure the compatibility between that product and the respective target clients. This obligation should apply in a proportionate manner depending, not only on the nature of the product (see paragraph 50), but also on the type of investment services that firms provide.
53. In this regard, it should be noted that, on one hand, the ex-ante assessment of the actual target market is influenced by the services provided, since it can be conducted more or less thoroughly depending on the level of client information available, which in turn depends on the type of services provided and the conduct of rules attached to their provision (in particular, investment advice and portfolio management allow for the acquisition of a wider set of information on clients compared to the other services). On the other hand, the target market assessment influences the decision on the type of services that are going to be provided in relation to the nature of the product and the circumstances and needs of the identified target clients, considering that the level of investor protection varies for different investment services, depending on the rules that apply at the point of sale. In particular, investment advice and portfolio management services allow for a higher degree of investor protection, compared to other services provided under the appropriateness regime or under execution-only.
54. It is therefore expected that when distributors define their product assortment, they pay particular attention to situations where they might not be able to conduct a thorough target market assessment by virtue of the type of services they provide. In particular, where



distributors only carry out execution services with the assessment of appropriateness (for example through a brokerage platform), they should consider that they will usually be able to conduct an assessment of the actual target market which is limited to the sole categories of clients' knowledge and experience (see paragraph 19(b)); where they only conduct execution services under the execution-only regime, not even the assessment of clients' knowledge and experience will usually be possible.<sup>39</sup> In this respect, firms should pay particular attention to the distribution strategy suggested by the manufacturer (see paragraph 33, 59 to 61).

55. This is especially relevant for products characterised by complexity/risk features (or other relevant features such as, for example, innovation), as well as for situations where there might be significant conflicts of interest (such as in relation to products issued by entities within the firm's group or when distributors receive inducements from third parties), being also mindful of the limited level of protection afforded to clients at the point of sale by the appropriateness test (or no protection at all, in the case of execution-only). In such circumstances, it is most important that distributors take into due consideration all relevant information provided by the product manufacturer, both in terms of potential target market and distribution strategy. For example, where the manufacturer's target market describes a product with particular features which requires, not only detailed client's knowledge and experience, but also a specific financial situation as well as unique objectives/needs, the distributor may decide to adopt a prudent approach by not including it in its product assortment (even though the firm would be in the position to assess ex-ante the compatibility of that product with its client base in terms of knowledge and experience).
56. Moreover, taking into account that the client's protection decreases when information available is not sufficient to ensure a full target market assessment, distributors may also decide to let clients operate on a non-advised basis after warning them that the firm is not in the position to assess their full compatibility with such products. In any case, as mentioned in paragraph 60, this decision should always be based on the consideration of the product's features (e.g., in terms of costs/complexity), as well as on other relevant situations (such as the occurrence of conflicts of interest in case of self-placement or inducements). Therefore, products should not be distributed under non-advised sales if the distributor cannot reasonably expect (i.e., ex-ante) that the distribution strategy for the product (including its marketing and information strategy) will generally enable the product to reach the identified target market. Likewise, providing a warning that the firm is not in the position to assess a client's full compatibility with a product does not exempt the firm from the obligation to review products, also taking into consideration any sales outside of the target market (see also paragraph 72).
57. On the contrary, if distributors intend to approach clients or prospective clients in any way to recommend or actively market a product or consider that product for the provision of

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<sup>39</sup> As explained above (see paragraph 45), for the definition of the target market, in addition to information gathered through investment or ancillary services, distributors could use any further information and data deemed reasonably useful that may be at their disposal and gathered through other sources. Therefore, even firms only providing investment services under appropriateness or execution-only regime, could be in the position to conduct a more thorough assessment of the target market.



portfolio management, then a thorough assessment of the target market should always be conducted.

### **Distribution strategy of the distributor**

58. The distributor should take the distribution strategy identified by the manufacturer into account and review it with a critical look. However, ultimately, including when a manufacturer is an entity not subject to MiFID II and thus it is not obliged to identify a distribution strategy, the distributor should define its own distribution strategy in light of information on its client base and type of services provided.

59. Considering the nature of the product and the investment service, distributors should refine the distribution strategy as identified by the manufacturer taking into account the characteristics of the distributor's client base. In particular, in making such a refinement, where the distributor considers that a more complex product with a relatively narrow target market can also be distributed under non-advised services, it should identify additional measures to ensure that the distribution strategy is compatible with the product's target market. In such cases, distributors should consider aspects such as:

- What marketing strategy should be followed for the product (e.g., active marketing, the use of nudging and/or gamification techniques, 'finfluencers'<sup>40</sup>, and so on). For example, a distributor could decide to make a more complex product only available when requested by the client and not to actively market it or use any gamification techniques or finfluencers in the distribution of such a product to its clients; and
- Whether and how the product should be displayed in the client's choice environment. For example, a distributor could decide not to show a more complex product on a prominent place on the website or at the top of a client's search results, or could decide to show such a product only if the client specifically requests it.

60. In particular, while taking into due consideration the suggested distribution strategy of the manufacturer, the distributor could decide to follow a more prudent approach by providing investment services that afford a higher level of protection to investors, such as investment advice. For instance, if the manufacturer considers that the features of a given product are compatible with a distribution strategy through non-advised services, the distributor may still decide that the characteristics of its existing or prospective clients (for example, very limited knowledge and no experience with investments in that type of product, unstable financial situation and very short-term objectives) are such that investment advice would be the most appropriate choice to ensure their best interests.

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<sup>40</sup> An influencer is usually someone who is active on social media and has:

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

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

61. On the contrary, the distributor could decide, in certain circumstances, to take a less prudent approach in relation to the distribution strategy defined by the manufacturer. For example, if the manufacturer deems that a given product, due to its specific features, should be offered through investment advice, the distributor could still make that product available through execution services to a specific segment of clients. In these situations, ESMA expects that the distributor would do so only after a thorough analysis of the features of the products and the target clients. Moreover, this decision should be reported to the manufacturer as part of the distributor's obligation to provide the manufacturer with sales information in a way that the manufacturer can take it into account in their product governance process and when selecting suitable distributors (as described in paragraph 32 and 33).

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

62. When providing investment advice, adopting a portfolio approach, and portfolio management to the client, the distributor can use products for diversification and hedging purposes. In this context, products can be sold outside of the product target market, if the portfolio as a whole or the combination of a financial instrument with its hedge is suitable for the client. Sales outside of the positive product target market can also occur in relation to the sustainability-related objectives of the product, provided that the approach is consistent with the approach outlined in the ESMA suitability guidelines<sup>41</sup>.

63. The identification of a target market by the distributor is without prejudice to the assessment of suitability. This means that, in certain cases, permissible deviations between the target market identification and the individual eligibility of the client may occur if the recommendation or sale of the product fulfils the suitability requirements conducted with a portfolio view as well as all other applicable legal requirements (including those relating to disclosure, identification and management of conflicts of interest, remuneration and inducements).

64. Providing investment advice, adopting a portfolio approach, or portfolio management services does not exempt the firm from defining a target market for each product to be distributed and from monitoring deviations from the target market to ensure that products are only distributed outside the target market when this can be justified for diversification or hedging purposes. For this purpose, deviations from the product's target market categories "client type" and "clients' knowledge and experience" cannot be justified for diversification or hedging purposes. However, in the case of portfolio management, given the specific nature of the service, the level of "clients' knowledge and experience" of the target market may take into account the approach set out in the ESMA suitability guidelines<sup>42</sup>.

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<sup>41</sup> Paragraph 88 of the ESMA suitability guidelines (ESMA35-43-3172).

<sup>42</sup> In particular, the second bullet point of paragraph 38 of the ESMA suitability guidelines explains "(...) when portfolio management is to be provided, as investment decisions are to be made by the firm on behalf of the client, the level of knowledge and experience needed by the client with regard to all the financial instruments that can potentially make up the portfolio may be

65. The distributor is not required to report sales outside of the positive target market to the manufacturer if these sales are for diversification and hedging purposes and if these sales are still suitable given the client's total portfolio or the risk being hedged.
66. Sales of products into the negative target market should always be reported to the manufacturer and disclosed to the client, even if those sales are for diversification or hedging purposes. Moreover, even if for diversification purposes, sales into the negative target market should be a rare occurrence (see also paragraphs 80-88).

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

67. Article 16(3) MiFID II and Articles 9 and 10 of the MiFID II Delegated Directive require manufacturers and distributors to review products on a regular basis to assess whether the product remains consistent with the needs, characteristics and objectives, including any sustainability-related objectives, of the identified target market and whether the intended distribution strategy remains appropriate.
68. Firms should use both quantitative and qualitative criteria to review products, relating to the product's characteristics (e.g., changes in the product's risk factors, investment strategy, cost structure (e.g., level and types of costs)), market conditions (e.g., adverse market conditions, regulatory developments) and distribution (e.g., client complaints, sales outside the target market, results from client surveys, online client trading behaviour). Firms should determine the frequency and depth of product reviews while taking into account the nature of the product and, where appropriate, the service. For example, for certain simpler products distributed under the execution-only exemption, product reviews can be less frequent and require less depth, and ad-hoc reviews can in such cases to a large extent be driven by client complaints and/or market events that significantly affect the product's risk-return profile. A manufacturer that has advised a corporate issuer on the launch of a new product, may also apply the review obligation for that product in a proportionate manner, irrespective of whether it concerns a simpler or more complex product.
69. Manufacturers should consider, on a proportionate basis, what information they need in order to complete their review and how to gather that information. In line with Recital 20 of the MiFID II Delegated Directive, relevant information could include, for example, information on which distribution channels have been employed, the proportion of sales made outside the target market, summary information of the types of clients, a summary of any complaints received, and questions suggested by the manufacturer to a sample of clients for feedback. Such information may be in an aggregated form and does not need to be on an instrument-by-instrument or sales-by-sales basis.
70. To support reviews by manufacturers, distributors must provide them with information on sales and, where appropriate, any other relevant information that may be the outcome of

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less detailed than the level that the client should have when an investment advice service is to be provided. Nevertheless, even in such situations, the client should at least understand the overall risks of the portfolio and possess a general understanding of the risks linked to each type of financial instrument that can be included in the portfolio. Firms should gain a very clear understanding and knowledge of the investment profile of the client".

the distributor's own periodic review. Whenever distributors have relevant information to support reviews by manufacturers, they should proactively provide it to the manufacturer and not provide such information only at the manufacturer's request. Furthermore, distributors should consider data and information that may give an indication that they have wrongly identified the target market for a specific product or service or that the product or service no longer meets the circumstances of the identified target market, such as where the product becomes illiquid or very volatile due to market changes. Any such information is subject to the proportionality principle and may generally be in an aggregated form and does not generally need to be on an instrument-by-instrument or sale-by-sale basis. However, instrument-specific information should be provided in cases with particular relevance for certain individual instruments (e.g., if the distributor comes to the conclusion that a target market for a specific product was wrongly determined).

71. In relation to the reporting of information on sales outside the manufacturer's target market, distributors should be able to report any decisions they have taken to sell outside the target market or to broaden the distribution strategy recommended by the manufacturer and information on sales made outside the target market (including sales within the negative target market), taking into account the exceptions as noted in paragraph 65.
72. For the purposes of their own review, distributors should determine what information they need in order to be able to draw reliable conclusions on whether products have been distributed to the identified target market. To be able to draw such reliable conclusions, firms may need to gather further information about their clients. Furthermore, firms should reconsider their distribution strategy for more complex products distributed through non-advised sales, if, for example, the review shows that such products are too often distributed outside the positive target market (or even in the negative target market).
73. Distributors are required to review products as long as they are offered, sold or recommended. For example, where a distributor no longer offers<sup>43</sup>, sells or recommends<sup>44</sup> a product, the distributor is no longer obliged to review the target market of that product, despite that a client may still have investments in that product. Where a distributor recommends to its clients to hold a product it no longer offers or sells, it should still undertake a review of the target market of that product prior to making that recommendation.

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

74. Firms that distribute products, that have not been manufactured by entities subject to the MiFID II product governance requirements, are expected to perform the necessary due diligence so as to provide an appropriate level of service and security to their clients compared to a situation where the product had been designed in accordance with the MiFID II product governance requirements.

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<sup>43</sup> In this context, 'offered' has a wide application and should be read in a broad sense.

<sup>44</sup> A firm recommends a product to a client if it recommends a client to either buy, hold or sell a product.

75. Where a product has not been designed in accordance with the MiFID II product governance requirements (for example, in the case of products issued by entities that are not subject to the MiFID II product governance requirements), this may affect the information gathering process or the target market identification:

- Target market definition: The distributor shall determine the target market also when the target market is not defined by the manufacturer<sup>45</sup> (see paragraph 42). Therefore, even where the firm does not receive a description of the target market from the manufacturer or information on the product approval process, it has to define its “own” target market. This should be done in an appropriate and proportionate manner (see paragraph 23).
- Information gathering process: distributors shall take all reasonable steps to ensure that the level of product information obtained from the manufacturer is of a reliable and adequate standard, to ensure that products will be distributed in accordance with the characteristics, objectives and needs of the target market<sup>46</sup>. 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<sup>47</sup>. For example, information disclosed in compliance with requirements in the Prospectus Directive, the Transparency Directive, the UCITS Directive, the AIFMD Directive or third-country equivalent requirements are acceptable.

76. The obligation referred to in paragraph 75 is relevant for products sold on primary and secondary markets and shall apply in a proportionate manner, depending on the degree to which publicly available information is available and the complexity of the product<sup>48</sup>. Thus, information about simpler, more common products, such as ordinary shares, will usually not require an agreement with the manufacturer but can be derived from the manifold information sources published for regulatory purposes for such products.

77. Where the distributor is not in a position to obtain in any way sufficient information on products manufactured by entities not subject to the MiFID II product governance requirements, the firm would be unable to meet its obligations under MiFID II and, consequently, should refrain from including them in its product assortment.

### **Application of product governance requirements to the distribution of products that were manufactured before the date of application of MIFID II.**

78. Products which were manufactured before 3 January 2018 and continue to be distributed to investors should fall within the scope of product governance requirements applicable to

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<sup>45</sup> See Article 10(1) of the MiFID II Delegated Directive.

<sup>46</sup> See subparagraph 3 of Article 10(2) of the MiFID II Delegated Directive.

<sup>47</sup> See Article 10(2) of the MiFID II Delegated Directive.

<sup>48</sup> See subparagraph 3 of Article 10(2) of the MiFID II Delegated Directive.

distributors, in particular, the requirement to identify a target market for any product. In this situation, the distributor should act as if the manufacturer was an entity not subject to MiFID II product governance requirements. When the target market has been identified by the manufacturer (on a voluntary basis / on the basis of commercial agreements with distributors) in line with these guidelines, the distributor, after reviewing it with a critical look, could rely on this target market identification.

79. However, a target market should be assigned by the manufacturer to such products, at the latest, following the next product review process cycle conducted according to Article 16(3) of MiFID II after 3 January 2018. The distributor should then consider this target market in its own review process.

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

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

80. The firm needs to consider whether the product would be incompatible with certain target clients (“negative” target market)<sup>49</sup>. When doing so, the firm should apply the same categories and principles as stated above in paragraphs 14-22 and 42-49. In line with the approach followed for the identification of the ‘positive’ target market, the manufacturer, who does not have a direct relationship with end-clients, will be able to identify the negative target market on a theoretical basis, i.e. with a more general view on how the specificities of a given product would not be compatible with certain groups of investors; the distributor, taking into account the manufacturer’s more general negative target market as well as information on its own client base, will be in the position to identify more concretely the group of clients to whom it should not distribute that specific product. In addition, the distributor is also required to identify any group(s) of clients for whose needs, characteristics and objectives, a service related to the distribution of a certain product would not be compatible.

81. For products which consider sustainability factors, firms are not required to identify a negative target market with respect to their sustainability-related objectives. This means that the sustainability-related objectives of products only contribute to identify a “positive” target market in terms of clients (groups of clients) with compatible sustainability-related objectives. The same products could still be distributed to clients falling outside that “positive” sustainability-related target market objective, provided that they are compatible with the features of the other target markets categories defined by these guidelines<sup>50</sup>. Hence, for products which consider sustainability factors, the firm should always perform a negative target market assessment with respect to the five target market categories

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<sup>49</sup> See Articles 9(9) and 10(2) of the MiFID II Delegated Directive.

<sup>50</sup> Recital 7 of Delegated Directive (EU) 2021/1269 explains that “To ensure that financial instruments with sustainability factors remain easily available also for clients that do not have sustainability preferences, investment firms should not be required to identify groups of clients with whose needs, characteristics and objectives the financial instrument with sustainability factors is not compatible”.



(client type, knowledge and experience, financial situation, risk tolerance and objectives and needs), but should not consider the sustainability-related objectives of the products. This is to assess whether these other target market aspects might be incompatible with certain clients, for example, if the product that considers sustainability factors concerns a risky product intended for clients with a long-term investment horizon and willing and able to lose their investment amount (in which case the product would not be compatible with clients that would have a low risk tolerance, whether or not their sustainability preferences are compatible with the sustainability-related objectives of the product).

82. Some of the target market characteristics used in the positive target market assessment by manufacturers and distributors will automatically lead to opposing characteristics for investors for whom the product is not compatible (for example, if a product is made for the investment objective “speculation” it will at the same time not be suitable for “low risk” objectives). In this case, a firm could define the negative target market by stating that the product or service is incompatible for any client outside the positive target market.
83. Again, it is important to take account of the principle of proportionality. When assessing a potential negative target market, the number and detail of factors and criteria will depend on the nature, especially the complexity or the risk-reward profile, of the product (i.e., a plain vanilla product is likely to have a smaller group of possible investors for whom it is incompatible, while the group of clients for whom the financial instrument is not compatible might be large for a more complex product).
84. There might be situations where products could, under certain circumstances and where all other legal requirements are met (including those relating to disclosure, suitability or appropriateness, identification and management of conflicts of interest), be sold outside the positive target market. However, these instances should be justified by the individual facts of the case, the reason for the deviation should be clearly documented and, where provided, included in the suitability report.
85. As the negative target market is an explicit indication of those clients for whose needs, characteristics and objectives the product is not compatible and to whom the product should not be distributed. The sale to investors within this group should be a rare occurrence, the justification for the deviation should be accordingly significant and is generally expected to be more substantiated than a justification for a sale outside the positive target market.
86. For example, the sale of products outside the target market could occur as a result of non-advised sales (i.e. where clients approach a firm to purchase a certain product without any active marketing by the firm or having been influenced in any way by that firm), where the firm does not have all the necessary information to conduct a thorough assessment of whether the client falls within the target market, which might be the case, for instance, for execution platforms that only operate under the appropriateness regime. It is expected that in the context of product governance arrangements, firms analyse ex-ante situations such as the one described, and make a responsible decision on how they are going to address them should they occur, and that client-facing employees are informed of the approach defined at management body level, so that they can comply with it. Firms should also take



into consideration the nature of the products included in the range of those they intend to offer to clients (for example, in terms of complexity/risk) and the existence of any conflicts of interest with clients (such as in the case of self-placement), as well as their business model. Some firms could, for example, consider the possibility of not allowing clients to operate if they fall within the negative target market, while letting other clients transact on a product that is in the 'grey' area, i.e., between the positive and negative target markets.

87. It is important that if the distributor becomes aware, for example, through the analysis of clients' complaints or other sources and data, that the sale of a certain product outside the target market identified ex-ante has become a significant phenomenon (for instance, in terms of number of clients involved), such input will be taken into due consideration in the course of its periodic review of the products and related services offered. In such cases, the distributor may, for example, come to the conclusion that the target market originally identified was not correct and that it needs to be reviewed or that the related distribution strategy was not appropriate for the product and has to be reconsidered.
88. Deviations from the target market (outside the positive or within the negative) which may be relevant for the product governance process of the manufacturer (especially those that are recurrent) should be reported to the manufacturer taking into account the exceptions as noted in paragraph 65.

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

*Professional clients and eligible counterparties as part of the intermediation chain*

89. The requirements set out in Article 16(3) and 24(2) of MiFID II apply to services and products manufactured and/distributed to retail and professional clients. At the same time, these articles specify that the clients to be targeted shall be the "end-clients". This means that a firm does not need to specify a target market for other firms (professional clients and eligible counterparties) within the intermediation chain, but rather it needs to design the target market with the end-client in mind (i.e., the final client in the intermediation chain). The specific type of end-client targeted is to be stated in the client-type category referred to in paragraph 19(a).
90. Where a professional client or an eligible counterparty buys a product with the intention to sell it on to other clients, therefore acting as a link in the intermediation chain, they should not be considered as "end-clients".
91. In such a case, the professional client (or eligible counterparty) would be acting as distributor and therefore should comply with the product governance requirements applicable to distributors.
92. For example, if a firm sells a product to an eligible counterparty that buys the product with the intention of distributing it more widely to professional or retail clients, the eligible counterparty should reassess the relevant target market in line with its obligations as a distributor. If the eligible counterparty then makes changes to the product before onward

distribution, this is likely to mean that it must comply with the product governance provisions for manufacturers as well as those for distributors.

*Professional clients as end-clients*

93. The MiFID client categorisation framework calibrates conduct of business protections to the needs of each client category (i.e., retail clients, professional clients and eligible counterparties).
94. Firms are entitled to assume that professional clients have the required knowledge and experience to understand the risks attached to the particular products or services for which they have been classified as a professional client<sup>51</sup>. MiFID II, nonetheless, makes a distinction 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.
95. Therefore, firms should, when carrying out their target market identification, consider the differences in assumed knowledge between retail and professional clients and, within the professional client category, elective professional clients and per se professional clients<sup>52</sup>. For example, the contrast in approach should take account of the differences in the knowledge and experience profiles of these different client categories.
96. It is possible that some products (for example those that are suitable for distribution in mass retail markets) will have a widely defined target market that might include both retail and professional clients. Such products, for example, units or shares in an ordinary UCITS fund, could, by default, be regarded as having a target market that includes professional clients. However, some other products, in particular products that have complex risk profiles, will have a more narrowly defined target market. For instance, the target market for a contingent convertible bond might be only composed of per se professional or elective professional clients who are likely to understand the complexities associated with these products.

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<sup>51</sup> See Annex II of MiFID II.

<sup>52</sup> See subparagraph 2 of section II.1 of Annex II of MiFID II.

### 3.6 Annex VI - Good practices

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

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

#	<i>Areas of product governance</i>	<i>Good practices</i>
		<p>manufacturer to better understand the rationale behind important decisions made in the manufacturer's target market assessment.</p>
5		<p>Distributors and manufacturers setting clear and detailed rules in their distribution agreements about the extent of information to be exchanged by them, the timing and the means to be used for this purpose.</p>
6		<p>Distributors of investment funds requesting the same level of information from non-MiFID manufacturers as from MiFID-manufacturers to be able to properly identify the target market for such products.</p>
7		<p>When assessing the compatible distribution strategy for a given product, restricting its distribution to advised sales only while the manufacturer also identified non-advised sales as compatible, for example because the product is considered too complex for non-advised sales or because the product is characterised by conflicts of interest. Such a decision is also reported to the manufacturer because it is relevant information for the manufacturer's periodic review of the product.</p>
8	<p><b><u>Distribution strategy distributor</u></b></p>	<p>Implementing blocking mechanisms in the distributor's systems to ensure that the product is distributed to the identified target market to effectively limit the possibility of sales outside the positive target market and/or into the negative target market (depending on the predefined distribution strategy). For example, blocks limiting sales to retail clients of products that have professional clients (and eligible counterparties) as a target market, or limiting sales to retail clients with basic knowledge and experience of products with a target market of advanced/very experienced clients.</p>
9	<p><b><u>Timing and relationship with other product governance processes</u></b></p>	<p>Comparing a possible new product with existing products in the distributor's offer, in terms of complexity, costs and risks, before deciding whether</p>

#	<i>Areas of product governance</i>	<i>Good practices</i>
		to include or replace it in the distributor's offer. For example, a firm could decide not to include a more expensive product in its product offer, with otherwise comparable product characteristics to a less expensive product that is already included in its product offer.
10		When defining the actual target market of certain products, for example in relation to clients' risk tolerance or financial situation and ability to bear losses, the firm decides that, based on the portfolio approach adopted for suitability assessment, such products can be sold to clients that fall outside the positive target market only up to a certain pre-defined percentage of such clients' assets.
11		Refining the granularity of the product clustering based on the outcomes of a product review, for example by developing more granular clustering of fixed-income instruments in terms of their credit rating.
12	<b><u>Product review (by the manufacturer or the distributor)</u></b>	Removing certain products from the product offer because the outcomes of the product review revealed that they do not longer offer value for money, for example due to falling interest rates.

## 3.7 Annex VII - Illustrative examples and case studies related to the application of certain aspects of the guidelines

### Case studies

#### Case study 1 - Structured product

##### Product

A six-year term product linked to the performance of shares of three blue-chip companies (one bank, one oil company and one technology stock).

At the end of the term, if all three shares are priced at above the initial value, the product aims to repay the investor's initial capital plus the average capital return of the three shares.

If one or more of the shares has fallen below the initial value by the end of the term (but not by more than 50%), the product aims to return the initial capital at the end of the term.

After six years, if the final price of any of the three shares is below 50% of its initial value, the investor suffers capital loss in line with the worst performing company.

The underlying components (the derivatives and fixed interest securities) are issued by the same investment bank, which has a low investment-grade credit rating.

The product has a legal structure of notes issued by an unlisted special purpose vehicle based outside the EEA but is packaged by an EU-based regulated firm. A prospectus is issued in accordance with the Prospectus Directive.

##### Target market

- Type of clients: retail, professional clients and eligible counterparties
- Clients' knowledge and experience:
  - experience with direct investment in structured products
  - understanding of what factors drive the movement of share prices and of how the movement of share prices impacts the value of the product
  - ability to understand the benefits of diversification and limited downside protection
  - understanding of counterparty risk and the credit rating of the bank that issued the underlying components, including any added risks arising from firms in different jurisdictions working together, and

- understanding of the main assumptions behind the investment proposition, including the scenario analysis performed by the manufacturer
- Clients' financial situation with a focus on the ability to bear losses: ability to tie money up for six years and to bear a 100% capital loss
- Clients' risk tolerance and compatibility of the risk/reward profile of the product with the target market:
  - financial ability and willingness to put the entire capital invested at risk, and
  - willingness to forego the benefits of diversification in exchange for limited downside protection
- Clients' objectives and needs: looking for the possibility of capital growth only over the medium-term (six-year term investment horizon), and expectation that, at expiry, none of the stocks will be worth less than 50% of the initial valuation.
- Clients who should not invest (the 'negative target market'): clients lacking the requisite knowledge and experience; clients with an investment horizon shorter than 6 years; and clients lacking the ability to tolerate the risks of the investment are deemed incompatible with the characteristics of this product.
- Distribution channel: In light of the target market analysis, the optimal retail distribution channel for the product is via advised sales only. This will allow evaluation of whether the client fits into the target market.

### Case study 2 - Structured deposit product target market case study

#### Product

A six-year term product linked to the performance of the main share index of the Member State of the issuing firm.

At the end of the term, if the index is at 100% or more than its initial level, the plan aims to provide a return at maturity of the initial investment plus 15%.

If the index has fallen below the initial value by the end of the term, the product aims to return the initial capital at the end of the term.

The product has the legal structure of a structured deposit issued by a bank. Each investor holds a deposit account.

#### Target market



- Type of clients: retail, professional clients and eligible counterparties
- Clients' knowledge and experience:
  - some knowledge or experience of the share index and the index mechanics
  - understanding of the possibility of inflation eroding value if the stock market falls over the investment term
  - understanding of the risk/reward profile of the product compared to currently-available term deposit accounts of the same duration and tracker fund
  - understanding of the main assumptions behind the investment proposition, including the scenario analysis performed by the manufacturer
  - understanding the most likely pay-off at maturity
- Clients' financial situation with a focus on the ability to bear losses: ability to tie money up for six years
- Clients' risk tolerance and compatibility of the risk/reward profile of the product with the target market: willing to accept possibly lower returns in order to seek protection against capital loss
- Clients' objectives and needs:
  - looking for possibility of capital growth only
  - looking for the potential of earning a greater return than in a comparable deposit account
  - six-year term investment horizon
- Clients who should not invest (the 'negative-target market'): this product is deemed incompatible for clients which:
  - need early access to the capital
  - are unwilling to accept the possibility of inflation eroding value, if the stock market falls over the investment term, or
  - would have their savings objectives materially affected if they only receive back the original capital amount

Distribution channel

- In light of the target market analysis, the product can be promoted with or without advice, with no additional requirements or restrictions on distributors
- The product should be sold only in the home state to avoid creating complications with cross-border business (for example, involving possible currency movements or complexities in the recourse to the Deposit Guarantee Scheme)

*Case study 3: Target market assessments relevant to distribution in wholesale markets (i.e. to professional clients and eligible counterparties).*

Example 1

A firm sells a product to an eligible counterparty; the eligible counterparty buys the product with the stated aim of structuring a packaged product for onward distribution to professional and/or retail clients. In this case, the firm selling the product must ensure that the proper information is provided to the eligible counterparty in respect of the product.

Furthermore, before onward distribution to professional and/or retail clients, the eligible counterparty will also have to comply with the product governance provisions for manufacturers as well as those for distributors in relation to the new packaged product.

Example 2

This scenario is identical to example 1, except that the firm selling the product to the eligible counterparty is unaware that the eligible counterparty intends to distribute the same product, without any packaging, more widely to professional and/or retail clients. As such, the eligible counterparty would be considered by the firm as an “end-client” in respect of its target market assessment.

If the eligible counterparty subsequently decides to further distribute the product, it will be responsible for acquiring the relevant information from the firm (i.e., the manufacturer) in order to carry out its own target market assessment. This assessment is likely to be more detailed than the target market assessment initially carried out by the manufacturer that has only eligible counterparties as end-clients. The eligible counterparty should keep communication channels as clear as possible with the firm, ensuring that it acquires all necessary information for the purposes of carrying out its own target market assessment and that any required information on the product is passed back to the firm (i.e., so that the firm can discharge its own obligations as a manufacturer).

As set out in example 1, if the eligible counterparty makes any changes to the product, it will likely need to comply with the product governance provisions for manufacturers as well as those for distributors.

#### Case-study 4: Target market assessment of a share

##### Product

Ordinary bearer share of a European blue-chip stock-corporation company from the automotive industry, listed on a regulated market in a prime index.

##### Target market

- Type of clients: retail, professional clients and eligible counterparties
- Clients' knowledge and experience: clients with basic capital markets knowledge or experience about shares. Given the amount of information available through e.g., press and mandatory disclosures, knowledge and experience requirements for such products are generally low.
- Clients' financial situation with a focus on the ability to bear losses: ability to bear 100% capital loss.
- Clients' risk tolerance and compatibility of the risk/reward profile of the product with the target market: due to the volatility of stock markets and specific risk if investing in individual company shares, clients should have a medium to high-risk<sup>53</sup> tolerance. They should be willing to accept price fluctuations in exchange for the opportunity of higher returns.
- Clients' objectives and needs: mass-market shares are compatible with the needs of clients who seek capital growth or potential dividend returns. Mass-market shares, that are very liquid and easily disposable, can be suitable for any investment horizon.
- Clients who should not invest (the 'negative-target market'): this product is deemed incompatible for clients which:
  - are looking for full capital protection or full repayment of the amount invested
  - are fully risk averse/have no risk tolerance
  - need a fully guaranteed income or fully predictable return profile

##### Distribution channel:

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<sup>53</sup> In line with paragraph 22 of the guidelines, firms should clearly define concepts and terminology used

The product is eligible for all distribution channels (e.g., investment advice, portfolio management, non-advised sales and pure execution services)

### Case study 5 – Target market assessment of a non-complex UCITS

#### Product

Non-complex UCITS fund primarily investing in investment grade European bonds (government, money-market or corporate bonds).

#### Target market

The type of clients to whom the product is targeted

- Type of clients: given the nature of non-complex UCITS funds: retail, professional clients and eligible counterparties
- Clients' knowledge and experience: clients with basic capital markets knowledge or experience (about funds' and bonds' characteristics and risks)
- Clients' financial situation with a focus on the ability to bear losses: clients that can bear a [x]%<sup>54</sup> capital loss
- Clients' risk tolerance and compatibility of the risk/reward profile of the product with the target market: due to the volatility of the bond market, the product has an [x]<sup>55</sup> risk & reward profile and is therefore compatible with clients need to have a low to medium<sup>56</sup> risk tolerance. They should be willing to accept price fluctuations in exchange for the opportunity of possible higher returns
- Clients' objectives and needs: depending on the duration of the product, the UCITS may be suitable for clients who seek capital growth and have a medium-term investment horizon (at least 3 years<sup>57</sup>)
- Clients who should not invest (the 'negative-target market'): this product is deemed incompatible for clients which:
  - require full capital protection and / or seeking on-demand full repayment of the amounts invested

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<sup>54</sup> The firm should specify the percentage based on the characteristics of the product.

<sup>55</sup> The firm should use the risk indicator of the UCITS KIID.

<sup>56</sup> In line with paragraph 22 of the guidelines, firms should clearly define concepts and terminology used.

<sup>57</sup> The firm should quantify the investment horizon based on the specific duration of the product

- are fully risk averse/have no risk tolerance

### Distribution channel

The product is eligible for all distribution channels (e.g., investment advice, portfolio management, non-advised sales and pure execution services)

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

#### *Premium*

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

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

#### *Buying options*

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

#### *Writing options*

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

It is also possible to write a call option while the investor owns the underlying, this is called covered writing. In this case, if the call option ends into-the-money, the investor has the underlying value to deliver to the buyer of the option. This means that the writer of the option

does not face any losses due to the rising value of the underlying value. Therefore, the risk is much lower than for uncovered writing options.

### *Multiple leg strategies*

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

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

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

### Distribution strategy

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

1. A distinction between two types of accounts: “basic” and “advanced” accounts. By means of a tool that distinguishes clients based on the five target market categories, clients are directed to either one of these accounts.
2. For the “basic” account only ‘mass retail’ products are made available, excluding products like options.
3. In the “advanced” account also other products are accessible for the client, including options. Additional measures are taken before clients can start trading options.
4. If a client wants to buy an option, two steps have to be taken:
  - a. A passed appropriateness test specifically for options is required, assessing a client’s detailed knowledge and experience with respect to the functioning of options.

- b. A clear target market description of the specific option is shown taking into account the way it will be used by the client (for instance when the client wants to buy a call, the specific target market for buying a call option is shown) and the client actively has to accept or reject it. When the client rejects it, it is not possible to buy options.
- 5. If a client wants to write options or to set up option strategies:
  - a. An additional appropriateness test is necessary, assessing the client's knowledge and experience with respect to the additional risks of writing options (such as margin calls).
  - b. An agreement should be signed in which the client confirms that s(h)e understands the potential consequences of writing options or setting up option strategies, such as incurring high losses and meeting margin calls. In addition, the firm will contact the client to ask control questions to assess whether the client truly belongs to the target market.