

The Financial Supervisory Authority

**RULE No. 14/2018**  
**for the application of the Guidelines on MiFID II product governance requirements**

Based on the provisions of art. 1 para. (2), art. 2 para. (1) letters a) and d), art. 3 para. (1) letter b), art. 6 para. (2), as well of art. 14 of the Government Emergency Ordinance no. 93/2012 regarding the establishment, organisation and operation of the Financial Supervisory Authority, approved with alterations and completions by Law no.113/2013, with the subsequent alterations and completions,

in accordance with the provisions of art. 16 of the Regulation (EU) no. 1095/2010 of the European Parliament and of the Council of 24th November 2010 for the establishment of the European supervisory authority (European Securities and Markets Authority), for the modification of Decision no. 716/2009/EC and for the abrogation of Decision 2009/77/EC of the Commission,

based on art. 51, art. 81 para. (2) – (4), art. 277 and art. 280 of Law no. 126/2018 regarding the securities markets,

taking into consideration the provisions of Chapter III of the A.S.F./B.N.R. Regulation no. 10/04/2018 regarding the protection of securities and client-owned funds, the product governance obligations and the norms applicable when granting or receiving honorariums, commissions or other types of pecuniary or non - pecuniary benefits.

according to the deliberations conducted during the meeting of the Financial Supervisory Authority Council of 01.08.2018,

The Financial Supervisory Authority issues the present norm:

**Art. 1** - The Financial Supervisory Authority applies the *Guidelines on MiFID II product governance requirements*, provided in the annex which is an inherent part of the present norm.

**Art. 2** – The entities mentioned in art. 1 para. (1) of the *A.S.F./B.N.R. Regulation no. 10/4/2018 regarding the protection of securities and client-owned funds, the product governance obligations and the norms applicable when granting or receiving honorariums, commissions or other types of pecuniary or non - pecuniary benefits* have the obligation to observe the provisions of the Guidelines on MiFID II product governance requirements, in relation with the activity of production and distribution of investment products.

**Art. 3.** – The failure to observe the provisions of the present norm is sanctioned according to the stipulations of Title X of Law no. 126/2018 regarding the securities markets.

**Art. 4.** – The present norm is published in the Official Gazette of Romania, Part I and comes into force in 10 days from its publication in the Official Gazette of Romania.

Chairman of the Financial Supervisory Authority,  
Leonardo Badea

Bucharest, 02.08.2018  
No. 14

## Guidelines on MiFID II product governance requirements

### Table of Contents

I.	Scope .....	3
II.	Purpose .....	3
III.	Definitions .....	4
IV.	Compliance and reporting obligations.....	4
V.	Guidelines on the application of Articles 16(3) and 24(2) of MIFID II.....	5
V.1.	General .....	5
V.2.	Guidelines for manufacturers .....	5
V.3.	Guidelines for distributors .....	9
V.4.	Guidelines on issues applicable to both manufacturers and distributors .....	17

## **I.Scope**

### **Who?**

1. These guidelines apply to:
  - firms subject to any of the following requirements:
    - i. Article 9(3) of Directive 2014/65/EU<sup>1</sup> (MiFID II);
    - ii. Article 16(3) 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>2</sup> (MiFID II Delegated Directive).
  - competent authorities with supervisory oversight of the above firms.

### **What?**

2. These guidelines apply in relation to the requirements referred to in paragraph 1 of these guidelines; in particular, they concern the manufacturing or distribution of investment products.

### **When?**

3. These guidelines apply from 3 January 2018.

## **II. Purpose**

4. The purpose of these guidelines is to provide more clarity on the product governance obligations for firms set out in paragraph 1.
5. ESMA expects these guidelines to promote greater convergence in the implementation and application of the MiFID II requirements on product governance. In complying with these guidelines, ESMA anticipates a corresponding strengthening of investor protection. Annex V includes a number of illustrative examples. These examples do not form part of the guidelines but instead aim to assist firms and competent authorities in understanding how the guidelines apply.

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<sup>1</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>2</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).

### **III. Definitions**

6. For the purpose of these guidelines, the following definitions apply:
- ‘firms’ mean firms subject to the requirements set out in paragraph 1 and include investment firms (as defined in Article 4(1)(1) of MiFID II), including credit institutions when providing investment services and activities (within the meaning of 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 and external Alternative Investment Fund Managers (AIFMs) (as defined in Article 5(1)(a) of the AIFMD<sup>3</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<sup>4</sup> and Article 6(4)(a) and (b) of the AIFMD);
  - ‘investment product’ means a financial instrument (within the meaning of Article 4(1)(15) of MiFID II) or a structured deposit (within the meaning of Article 4(1)(43) of MiFID II);
  - ‘manufacturer’ means, taking into account Recital 15 and Article 9(1) of the MiFID II Delegated Directive, a firm that manufactures an investment product, including the creation, development, issuance or design of that product, including when advising corporate issuers on the launch of a new product;
  - ‘distributor’ means, taking into account Recital 15 and Article 10(1) of the MiFID II Delegated Directive, a firm that offers, recommends or sells an investment product and service to a client.

### **IV. Compliance and reporting obligations**

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

7. This document contains guidelines issued under Article 16 of the ESMA Regulation. In accordance with Article 16(3) of the ESMA Regulation, competent authorities and financial market participants must make every effort to comply with the guidelines.
8. Competent authorities to whom the guidelines apply should comply by incorporating them into their supervisory practices, including where particular guidelines are directed primarily at financial market participants.

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<sup>3</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).

<sup>4</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).

## **Reporting requirements**

9. Competent authorities to which these guidelines apply must notify ESMA whether they comply or intend to comply with the guidelines, stating their reasons for non-compliance where they do not comply or do not intend to comply, within two months of the date of publication of the guidelines on ESMA's website in all official languages of the EU.
  
10. Firms are not required to report to ESMA whether they comply with these guidelines.

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

### **v.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 investment product, the investment service and the target market of the product.
  
12. When a firm acts both as the manufacturer and distributor of investment products, the Guidelines set out below apply as relevant, and as long as the firm meets all the applicable manufacturer and distributor obligations.

### **v.2. Guidelines for manufacturers**

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

13. The potential target market identification by manufacturers should not be solely conducted on the basis of quantitative criteria but needs to be based on sufficient qualitative considerations as well. 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, rating of issuers, etc. or through "conversion" of factual data into numerical systems). With regard to the target market identification, firms

should not solely rely on such quantitative criteria but sufficiently balance them with qualitative considerations.

14. Manufacturers should use the list of categories set out in these guidelines as a basis for identifying the target market for their investment products. The list of the categories is cumulative: when assessing the target market, each manufacturer should use each of those categories. 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 paragraphs 18-24 of the guidelines).
15. When detailing/describing each one of these categories, manufacturers should take into account the relationship between different categories since they all contribute to the definition of the target market for a given product.
16. 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.
17. Manufacturers need to identify a potential target market<sup>5</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.
18. 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”.
  - (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 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 or the UCITS Directive, where applicable, to fulfil this requirement.

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<sup>5</sup> See Article 9(9) of the MiFID Delegated Directive.

- (e) Clients' Objectives and Needs: The firm should specify the investment objectives and needs of target clients that a product is designed to meet, including the wider financial goals of target clients or the overall strategy they follow when investing. For example, reference could be made to the expected investment horizon (number of years the investment is to be held). 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”, “green investment”, “ethical investment”, etc., as relevant.
19. 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.
20. 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 above.

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

21. The identification of the potential target market should be done in an appropriate and proportionate manner, considering the nature of the investment 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.
22. Consequently, for more complicated products, such as structured products with complicated return profiles, the target market should be identified with more detail. For simpler, more common products it is likely that the target market will be identified with less detail<sup>6</sup>:



- For some types of investment products the manufacturer may identify the above-mentioned target market categories referred to in paragraph 18 following a common approach for financial instruments of one type with sufficiently comparable product features (for example due to an external benchmark, or because they belong to a stock-exchange segment with certain requirements).
  - Depending on the investment 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.
23. However, in all cases, 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.
24. 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**

25. According to Article 16(3) of MiFID II, the manufacturer shall ensure that its intended distribution strategy is consistent with the identified target and, according to Article 24(2) of MiFID II, the manufacturer needs to take reasonable steps to ensure that the financial 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.
26. 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.

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<sup>6</sup> See Recital 19 of the MiFID II Delegated Directive.

### **V.3. Guidelines for distributors**

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

27. The distributor's target market identification (i.e. 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, when the firm's business policies and distribution strategies are defined by the management body and, on an *ex-ante* basis (i.e. before going into daily business).
28. In particular, distributors should take responsibility to ensure, from the very beginning, the general consistency of the products that are going to be offered and the related services that will be provided with the needs, characteristics and objectives of target clients.
29. 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.
30. 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>7</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 offered in accordance with appropriateness or suitability requirements, so as to grant a higher degree of protection to clients.
31. 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,

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<sup>7</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'.

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.

32. 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 refrain from including the product in its product assortment (i.e. the products that will be offered, to whom, and through the provision of which investment services).

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

33. The obligation of the distributor to identify the actual target market and to ensure that a product is distributed in accordance with the actual target market is not substituted by an assessment of suitability or appropriateness and has to be conducted in addition to, and before such 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 another group of clients with whom the product may not be compatible.

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

34. Distributors should use the same list of categories used by manufacturers (see paragraph 18), as a basis for defining the target market for their products. 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 investment products and the type of investment services they provide.

35. As 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.
36. 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.
37. 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.
38. 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. 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.

39. Usually, the target market assessment of the distributor will occur after the manufacturer has communicated its target market to him. 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.
40. 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**

41. 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 investment product, in line with what described in paragraphs 21 to 24.
42. 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**

43. 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 41 above), but also on the type of investment services that firms provide.
44. 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.
45. 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 18(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>8</sup> In this respect, firms should pay particular attention to the distribution strategy suggested by the manufacturer (see paragraphs 26, 49 to 51).
46. 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).

47. 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 having warned them that the firm is not in the position to assess their full compatibility with such products.
48. 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 portfolio management, then a thorough assessment of the target market should always be conducted.

## **Distribution strategy of the distributor**

49. 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.
50. 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

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<sup>8</sup> As explained above (see paragraph 36), 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.

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.

51. 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 paragraphs 21-22).

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

52. 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.
53. 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).
54. 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.

55. 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 67-74).

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

56. 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 of the identified target market and whether the intended distribution strategy remains appropriate.
57. 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 client, a summary of any complaints received and questions suggested by the manufacturer to a sample of clients for feedback. Such information may be in an aggregated form and does not need to be on an instrument-by-instrument or sales-by-sales basis.
58. To support reviews by MiFID manufacturers, distributors must provide them with information on sales and, where appropriate, any other relevant information that may be the outcome of the distributor's own periodic review. 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).

59. 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 54.

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

60. 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.

61. Where a product has not been designed in accordance with the MiFID II product governance requirements (for example, in the case of investment 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>9</sup> (see paragraph 34). 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 21).
- 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>10</sup>. Where all relevant information is not publicly available (for example, through the PRIIPs<sup>11</sup> 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>12</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.

62. The obligation referred to in paragraph 61 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>13</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.

63. 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.**

64. Products manufactured and distributed before 3 January 2018 should not fall within the scope of the product governance requirements as defined by MiFID II.

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

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<sup>9</sup> See Article 10(1) of the MiFID II Delegated Directive.

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

<sup>11</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).

<sup>12</sup> See Article 10(2) of the MiFID II Delegated Directive.

<sup>13</sup> See subparagraph 3 of Article 10(2) of the MiFID II Delegated Directive.

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

#### **V.4. Guidelines on issues applicable to both manufacturers and distributors**

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

67. The firm needs to consider whether the product would be incompatible with certain target clients (“negative” target market)<sup>14</sup>. When doing so, the firm should apply the same categories and principles as stated above in paragraphs 13-20 and 34-40. 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.

68. 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.

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<sup>14</sup> See Articles 9(9) and 10(2) of the MiFID II Delegated Directive.

69. 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).
70. 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.
71. 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.
72. 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 financial product that is in the 'grey' area, i.e. between the positive and negative target markets.

73. 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.
74. 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 54.

### **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*

75. The requirements set out in Article 16(3) MiFID II apply irrespective of the nature of the client (retail, professional or eligible counterparty). At the same time Articles 16(3) and 24(2) MiFID II 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 18(a).
76. 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".
77. 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.

78. 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 and eligible counterparties as end-clients*

79. 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). In a wholesale market context (which includes professional clients and eligible counterparties only), MiFID allows certain assumptions to be made about clients' knowledge and experience with respect to understanding investment risks.

80. MiFID II requires firms to ensure that the products they manufacture and/or distribute are designed to meet the needs of an identified target market of end-clients within the relevant category of clients<sup>15</sup>. As such, when assessing the appropriate target market for a particular product, firms should consider the appropriate client category and whether it allows them to make any assumptions about the end clients' knowledge and experience.

*For professional clients as end-clients*

81. 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>16</sup>. MiFID 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.

82. 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>17</sup>. For example, the contrast in approach should take account of the differences in the knowledge and experience profiles of these different client categories.

83. 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.

*For eligible counterparties as end-clients*

84. The MiFID regulatory framework recognises eligible counterparties as the most sophisticated class of investors and capital market participants, consequently switching off many of the conduct of business protections in respect of these clients. MiFID II however, seeks to increase the protections afforded to non-retail clients, extending certain information and reporting requirements to firms' dealings with eligible counterparties. While firms are not obliged to apply the requirements in Article 24 (with the exception of paragraphs 4 and 5) of MiFID II when entering into transactions with eligible counterparties (Article 30(1) of MiFID II), they will still need to ensure that they act "honestly, fairly and professionally" and communicate in a way that is "fair, clear and not misleading" in their dealings with eligible counterparties. Furthermore, the requirements set out in Article 16(3) of MiFID II apply irrespectively of the nature of the client (retail, professional or eligible counterparties).

85. Where the target market of end-clients is composed solely of eligible counterparties, the overall assessment is likely to be less comprehensive. Eligible counterparties will be likely to have a detailed understanding of the market environment, commercial viability and other key factors and risks associated with a particular investment decision.

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<sup>15</sup> See subparagraph 3 of Article 16(3) and Article 24(2) of MiFID II.

<sup>16</sup> See Annex II of MiFID II.

<sup>17</sup> See subparagraph 2 of section II.1 of Annex II of MiFID II.