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Client Alert
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Latham & Watkins Financial Regulatory Practice

5 June 2017 | Number 2155

ESMA Final Report on MiFID II Product Governance Requirements

ESMA Sheds Light on MiFID II Product Governance

The MiFID II Product Governance regime presents a number of implementation challenges for firms. The rules originated from an existing FCA regime, which derived from a need to protect retail investors who were sold complicated and/or risky investment products. MiFID II expanded these rules to capture all investment products (including mass-market non-complex) and all categories of investors (including wholesale in addition to retail markets). There was little, if any, tailoring of the previous retail complex products regime to account for this extension. Instead, firms can use "proportionality" when interpreting the rules in the context of their broader application. Firms have since grappled with where the proportionality dial should sit when establishing practical implementation frameworks. This Final Report from ESMA represents a significant clarification of the expectations of firms.

This *Client Alert* sets out Latham's current view of a typical target market categorisation in addition to some of the key points from the report:

- Target Market Categories
- Key Points for Manufacturers
- Key Points for Distributors
- Proportionality
  - Simple Products
  - Wholesale Markets
  - Secondary Markets
- Distributor Feedback
- Portfolio Diversification
- Acquisition Channels
- Next Steps

Note: ESMA has provided five example target market templates in relation to a **structured product**, a **structured deposit**, **wholesale markets**, a **share**, and a **non-complex UCITS**. These have been included as an Annex to this *Client Alert*.

Target Market Categories

Target Market Category	ESMA Guidance	Example Category
Client Type	The firm should specify at 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” (ECP).	• ECP • Professional • Retail
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. ESMA acknowledges the use of low, medium and high as an option (and importantly does not discredit this approach). ESMA does not plan to give firm guidance — beyond the scope of the guidelines — to set an industry standard (acknowledging the different practices firms use assess a client’s knowledge and experience). See **Key Points for Manufacturers** below as regards the need to produce guidance notes in relation to such high level categories.	• Low • Medium • High
Financial Situation with a Focus on the Ability to Bear Loss	The firm should specify the percentage of losses target clients should be able and willing to afford (for example, from minor losses to total losses) 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.	• Investor is not willing or able to bear any loss of their investment • Investor is willing and able to bear partial loss of their investment • Investor is willing and able to bear total loss of their investment • Investor is willing and able to bear losses greater than their investment

Risk Tolerance and Compatibility of the Risk/Reward Profile of the Product with the Target Market	The firm should specify the general attitudes that target clients should have in relation to the risks of investment. Basic risk attitudes should be categorised (for example, risk orientated or speculative, balanced, conservative) and clearly described. Firms should use the risk indicator stipulated by the PRIIPs Regulation or the UCITS Directive, where applicable, to fulfil this requirement.	For PRIIPs: • SRI Score _____________ For UCITS products: • SRRI Score _____________ For non-PRIIP / UCITS products: • Conservative • Balanced • Speculative
Client's Objectives and Needs	The "investment objectives" and "clients' needs" categories have been merged. 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 clients 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. ESMA notes that including an investment horizon in line with a PRIIPs recommended hold period makes sense. In relation to needs, ESMA has recognised that only products with a specific term *i.e.* green/ethical need to be included and not customer-specific needs (*e.g.* retirement provision/liquidity to supply). ESMA also clarifies that not all products will seek to address a specific need. Therefore, firms should consider whether this category is appropriate in all cases.	Investment objectives: • Income • Growth • Financing • Hedging • Trading Investment horizon: • Maturity date: _____________ • Recommended hold period: _____________ • Indicative: – Very short (less than 1 week) – Short (less than 1 year) – Medium (1-3 years) – Long (3+ years) Client needs: • Currency protection • Green investment • Ethical investment • Shariah compliant
Negative Target Market	See approach to Negative Target Market under **Proportionality — Simpler Products** below. ESMA has clarified that the identification of a group of target clients for which the product is compatible does not always automatically imply that the product is not compatible with all other clients. This rejects the attempt to adopt a binary approach whereby the negative target market corresponds to what does not fall in the positive one.	Do not sell to: • Retail – Execution only – Non-advised – Advised – Discretionary • Professional

Note that ESMA has confirmed that manufacturers should not exclude any of these five categories, but must instead rely on proportionality in relation to the level of detail at which the target market must be identified.

Key Points for Manufacturers

Guidance notes — ESMA helpfully has confirmed that the fact that a manufacturer's target is intended to be high level, coupled with the need to obtain industry alignment, means that a manufacturer may use relatively high level descriptions under certain target market categories (see the Knowledge and Experience and Risk Tolerance categories in the table above). However, ESMA has clarified that if a manufacturer does use high level descriptions, the concepts used should be clearly defined. For example, this could be by way of guidance notes produced by the manufacturer. Clearly, there is a strong need for industry alignment in the context of drafting these guidance notes. There are a number of formats currently under discussion, including narrative descriptions and linking to examples of products that illustrate the high level categories.

Products manufactured pre-3 January 2018 — Manufacturers should note that the previous position contained in the consultation (that manufacturers were not obliged to communicate target market in the case of products manufactured before 3 January 2018 and available for sale after that date) has changed. ESMA has clarified that it is keen to mitigate the implementation issues that this position causes distributors by encouraging manufacturers to provide the target market in such circumstances by way of good practice. This will also include a reciprocal obligation on distributors to provide distributor feedback on sales made outside the target markets where a manufacturer does communicate the target market in respect of products manufactured pre-3 January 2018.

Acquisition Channels — ESMA has helpfully clarified that there is no concrete requirement on manufacturers to specify the acquisition channel (*i.e.* face-to-face, telephone or online distribution). Instead, the manufacturer should propose the type of investment service through which the target clients should or could acquire the investment product. If the product is deemed appropriate for sale without advice, the firm *could* also specify the preferred acquisition channel.

Key Points for Distributors

Distribution Strategy — Distributors must take into account the manufacturer's distribution strategy. If a distributor decides to deviate from a manufacturer's distribution strategy, it must only do so where it has conducted a "thorough analysis" of the products and target client. Further, any decision to deviate from the manufacturer's distribution strategy must be reported to the manufacturer by way of distributor feedback. Manufacturers, in turn, should take this into account in their product governance process when selecting suitable distributors.

Third-Country Manufacturers — ESMA has previously referenced distributors' ability to rely on publicly available information produced to meet regulatory requirements when determining whether they need to enter into agreements with third-country manufacturers for the purpose of the product governance target market requirements. The assumption being that in the absence of such information, the distributor will be required to enter into an agreement with the third-country manufacturer, requiring it to provide the information the distributor will need to establish an appropriate target market. ESMA has clarified that if a third-country manufacturer has issued a UCITS KIID, PRIIPs KID or a prospectus under the Prospectus Directive (or any third-country equivalent regime) then the distributor is not required to enter into an agreement with the manufacturer for the purpose of the product governance target market requirements.

Products Manufactured Before 3 January 2018 — Please see **Key Points for Manufacturers**, above.

Linking Target Market to Investment Services

ESMA has responded to lobbying by distributors that in circumstances where they are acting on a non-advised basis, they will not hold information about the end-investor that would allow them to assess whether the end-investor was aligned with all of the relevant target market categories. This is because they would not be required to collect this information from the investor at take-on stage or throughout the life of the client relationship. ESMA has provided a significant clarification for firms to the effect that if a distributor does not otherwise hold information in relation to a client, the fact that the firm needs to consider a particular target market category does not mean that it needs to collect additional information from individual clients to be able to assess the relevant target market category. This means that distributors can now view their target market obligations broken down in terms of what they must assess and what they must disclose. A distributor is only required to assess information where it has collected that information in relation to a client by virtue of its obligations under other conduct rules (*e.g.* suitability and appropriateness). In all other cases, a distributor is only required to disclose that information to the client.

The table below illustrates the requirements:

Target Market Category	**Investment Services**					
	Execution Only *Non-complex product*	**Execution Only** *Complex product*		**Advice**		
	All Client Types	**Retail**	**Professional**	**Retail**	**Elective Professional**	**Per se Professional**
Client Type	Disclose	Assess	Assess	Assess	Assess	Assess
Knowledge and Experience	Disclose	Assess	Disclose	Assess	Assess*	Disclose
Financial Situation with a Focus on the Ability to Bear Loss	Disclose	Disclose	Disclose	Assess	Assess	Disclose
Risk Tolerance and Compatibility of the Risk/ Reward Profile of the Product	Disclose	Disclose	Disclose	Assess	Assess	Assess
Client's Objectives and Needs	Disclose	Disclose	Disclose	Assess	Assess	Assess

* **Note**: ESMA states in paragraphs 81 and 82 of its guidelines that firms should distinguish between the assumed knowledge and experience of elective professional and per se professional clients, referencing the new wording in section II of Annex II to MiFID II, which states that an elective professional should not be presumed to possess knowledge and experience comparable to a per se professional. Although this distinction is not tracked through into the suitability and appropriateness requirements (which allow firms to assume knowledge and experience in relation to all professionals), given ESMA's explicit mention of this distinction in its guidelines it would be prudent for firms not to assume that elective professional clients have the required knowledge and experience in relation to the product or service in question in a product governance context.

Firms must note the following points when implementing the approach above:

- **Client's Best Interests Rule** — Firms should decide the range of products they want to offer up front. This will involve having a pre-approved product distribution matrix that takes into account the complexity/risk of the product (plus other relevant features, *e.g.* innovation), plus existence of conflicts and the level of protection afforded to clients at point of sale. Firms should not let the rules-based system in the table above allow them to ignore the overriding obligation that they need to manage the risk of products ending up in the wrong hands. This aligns with Recital 71 of MiFID II, which specifies that the requirements on product governance apply without prejudice to any assessment of appropriateness or suitability the firm subsequently carries out in the provision of investment services to each client, on the basis of the client's personal needs, characteristics and objectives.

- **Target Market Disclosures** — Wherever a firm does not have enough information about a client to assess whether a particular target market category applies to them, the firm is under an obligation to disclose the target market. This includes warning the client that the firm is not in a position to conduct a thorough assessment of the client's compatibility with the product. Firms should consider how these standard disclosures can be built into product literature for all non-advised sales.

Proportionality

Simpler Products

- ESMA has provided further illustrative case studies in relation to non-complex UCITS and an ordinary share. Notably, ESMA categorises vanilla bonds as a simpler product when referencing ordinary shares and non-complex UCITS in the context of its feedback.

- ESMA considers that manufacturers and distributors can have a "bulk target market" for types of products/products of the same characteristics, instead of requiring a target market per product. In order for this bulk target market to apply, products must have sufficiently comparable product features. Such comparability is more likely to be the case in the context of simpler products.

- Clearly, if a product is intended for the mass retail market, there is unlikely to be a negative target market. Therefore, firms may invoke proportionality to remove the requirement to have a negative market in these circumstances.

- Since for mass-market products there should be no category of investor for whom the product is not suitable, the requirement to obtain feedback from distributors in relation to such products should be limited to reporting complaints.

Wholesale Markets

- ESMA clarifies that firms cannot remove the obligation to create a target market altogether for wholesale markets. However, a firm can have a less-comprehensively detailed target market assessment.

- Since distributors are only technically required to provide feedback with regard to sales inside the negative target market, and in the case of wholesale markets sales to a negative market should be rare for the vast majority of products, it is possible to conclude that distributor feedback will also be rare in these markets. Nevertheless, firms must take into account ESMA's general position in relation to wholesale markets, which is that firms must categorise different types of wholesale clients and build a framework that is appropriate in light of the relative sophistication of the client and the investment products being sold to them.

- ESMA has restated the importance of retaining the distinction between per se professionals and opt-up professionals when building a proportionate product governance framework. In fact, firms operating in wholesale markets may choose to break down their client base further by sophistication (hedge funds, pension funds, brokers, private banks, corporates) when considering an appropriate and proportionate implementation framework.

Secondary Markets

ESMA reminds firms that the Level 1 and 2 MiFID II texts specifically include obligations for manufacturers and distributors. Their objective is clearly not to hinder open architecture models but, on the contrary, to contribute to facilitating distributors' tasks to understand products and the end clients to which a product should be distributed, "including where there is no direct manufacturer-distributor relationship". Firms should take this as confirmation that there should be no blanket exclusion of product governance rules in respect of secondary market trading.

Distributor Feedback

ESMA has provided additional guidance for the types of information distributors must provide to manufacturers in the context of mass retail products and wholesale markets (see **Proportionality** above).

Aggregated/Product-By-Product Feedback — ESMA has clarified that reporting requirements are subject to the proportionality principle and may be done in an aggregated form. Therefore, distributor feedback does not generally need to be done on an instrument-by-instrument basis (*e.g.* for products with a "bulk target market" — interpreted here as meaning simpler products). Nevertheless, firms distributing complex products to retail investors may still require distributor feedback on a product-by-product basis.

Non-Advised Sales — Since confirming a deviation from the target market is not possible because not all target market categories will be assessed (see table under **Linking Target Market to Investment Services** above), firms may want to consider providing feedback in an aggregated form or otherwise use summary information the manufacturer provides on the types of clients, complaints received and questions suggested to a sample of clients for feedback.

Portfolio Diversification

Distributor Feedback — If a distributor takes into account the diversified nature of an investor's portfolio when assessing the suitability of a given product for an investor, ESMA clarifies that the distributor does not need to report information on sales outside the manufacturer's target market. Sales within the negative target market must always be reported.

Firms must not rely on the above in a non-advised context if a client unilaterally executes a transaction with a view to ensuring diversification. ESMA specifically warns that this interpretation/application of the concept of "diversification" is not correct.

Next Steps

ESMA states that it has not ruled out the development of further Level 3 work (*e.g.* Q & As) on other aspects of the MiFID II Product Governance framework. No doubt this will be highly welcomed by firms. Watch this space...

Annex

Illustrative examples and case studies taken from the ESMA guidelines

Case study 1 — Structured investment 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 [x]; 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 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

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]% 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] risk & reward profile and is therefore compatible with clients need to have a low to medium 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)
- 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
  - 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)

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