

ESMA issues guidelines on target market assessment under MiFID II

14 June 2017

In brief

The Directive 2014/65/EU on markets in financial instruments (“MiFID II”) has introduced product governance requirements to ensure that investment services firms that either manufacture or distribute financial instruments and structured deposits, act in the clients’ best interests during all the stages of the life-cycle of products or services.

In detail

On 2 June 2017, the European Securities and Markets Authority (“ESMA”) issued its final Guidelines (ESMA 2017/36-43-620, the “Final Report”) on product governance requirements as required under the MiFID II regime¹. The Guidelines focus on the “target market assessment” for both manufacturers and distributors. Before including a product into the distributor’s product assortment and selling it to clients, both sides will have to assess – *for each single product* - its target market, as well as its distribution strategy. This requirement emerges as being a significant and time consuming challenge in terms of information gathering and processing. Indeed, according to ESMA’s illustrative examples, the definition of a product’s target market could be about one-page long. Below we highlight the key points we believe will have important impacts on manufacturers and distributors.

1. **What manufacturers need to know**

As stated in the Final Report, manufacturers should take the **nature of the investment product** into account while defining its target market. In this context, ESMA set forth a list of five cumulative criteria that should be used by manufacturers. Besides the assessment of the positive target market, manufacturers will have to take all reasonable steps to assess the negative target market as well as their distribution strategy.

1.1 **Definition of the positive target market**

1.1.1 Client type: the manufacturer should specify to which type of client the product is targeted according to the MiFID II client categorisation as “retail client”, “professional client” and/or “eligible counterparty”. Country specific classifications such as “semi-professional” or “qualified investors” remain possible as far as technically accepted by the information providers.

¹ https://www.esma.europa.eu/sites/default/files/library/esma35-43-620_report_on_guidelines_on_product_governance.pdf

1.1.2 Client’s knowledge and experience: the manufacturer should specify which knowledge the target clients should have with regard to (i) the relevant product type, (ii) the product features, and/or experience in specific areas that help to understand the product.

1.1.3 Client financial situation and ability to bear losses: the manufacturer should specify the percentage of losses target clients should be able and willing to afford, including any additional payment obligations that might exceed the amount invested. For funds the options are limited since losses cannot exceed invested capital in general terms.

1.1.4 Risk tolerance and compatibility of the risk/reward profile of the product with the target market: the manufacturer should detail the general attitude that target clients should have in relation to the risks of investment. Basic risk-attitudes should be categorised and clearly described. Where relevant, investment firms should use the PRIIPS or UCITS Directive overall risk indicator (i.e. S(R)RI).

1.1.5 Clients’ objectives and needs: the manufacturer should specify the wider financial goals of target clients or the overall strategy they follow when investing. Reference could be made to the expected investment horizon. 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 such as:

- Specific age demographic,
- Country of tax residence,
- Special product features like “currency protection”, “green investment”, “ethical investment”, etc.

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.

1.2 Definition of the negative 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.

Some of the target market characteristics used in the positive target market assessment by manufacturers will automatically lead to obvious opposing characteristics (i.e. a product made for “speculation” purpose will not be suitable for investors with a “low risk” profile). 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.

The definition of these target market leads to create a so-called “**grey area**”, where some clients could fall in-between the positive and the negative market.

1.3 Definition of the distribution strategy

The manufacturer shall ensure that its distribution strategy is consistent with the identified target market of a product in order to favour the sale of each product and to meet the identified target market. In order to do so, the manufacturer should on a best efforts basis select distributors whose type of clients and services offered are compatible with the target market of the product.

Moreover, the 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 should also specify the preferred acquisition channel.

Keep in mind that the above described manufacturer obligations apply to MiFID firms manufacturing financial instruments. A UCITS management company or an AIFM are non-MiFID firms and, therefore, will only need to fulfil the contractual requirements agreed upon with their MiFID distributors (refer to section 2.5).

2. What distributors need to know

Under MiFID II, the distributor is required to assess the needs of the clients to whom they intend to offer or recommend a product, to make sure the product is compatible with its potential target clients.

ESMA stresses that the target market identification is distinct and serves a different purpose than the suitability and appropriateness tests.

2.1 Definition of the target market

Distributors should use at least the **same five categories** as manufacturers. 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 investment product, and
- the type of investment services they provide.

Moreover, 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.

2.2 Deviation from the manufacturer's target market definition

There might be situations where products could be sold to clients situated in the "**grey area**", i.e. between the positive and the negative market. However, these instances **should be justified** by the individual facts of the case and the reason for the deviation should be clearly documented and, where provided, included in the suitability report. The same would apply to the sale of products toward investors falling within the **negative market**. 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.

2.3 Distribution strategy

The distributor has to take the distribution strategy of the manufacturer into account and review it with a **critical look**.

The distributor could:

- Choose to follow a more prudent approach by providing investment services that afford a higher level of protection to investors, such as investment advice.
- Or could decide to take a less prudent approach in relation to the distribution strategy defined by the manufacturer. If a distributor should choose to take a less prudent approach he is expected to conduct a thorough analysis of the product and of the target clients.

2.4 Reporting obligations:

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. 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.

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),

2.5 Distribution of products manufactured by entities not subject to MiFID II:

Where a manufacturer falls outside the scope of MiFID II, the distributor should **determine its own target market** and its distribution strategy in light of information on its client base and type of services provided in the same way manufacturers would do. Distributors should ensure that the level of product information obtained from the manufacturer is of a **reliable and adequate standard**. On one hand, where all relevant information **is not publicly available**, distributors should enter into an agreement with the manufacturer or its agent in order to obtain all relevant information. On the other hand, where information is **publicly available**, it may only be accepted if it is clear, reliable and produced to fulfil the regulatory requirements.

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

Nevertheless, where the distributor is **not in the position to obtain in any way sufficient information** on products manufactured, the firm would be unable to meet its obligations under MiFID II and, consequently, should refrain from including them in its product assortment.

Additional insight from new Q&A from ESMA on investor protections

On 6 June 2017, ESMA issued an Q&A on MiFID II and MiFIR investor protection topics (ESMA35-43-349), which clarifies that *shares and units* in **non-UCITS collective investment undertakings are per se complex products**. As a result, when providing execution only services to retail clients, MiFID firms will have to **perform an appropriateness test for all transactions performed on Alternative Investment Funds (AIFs)**.

What's next? Stay Tuned!

MiFID II will come into force on 3 January 2018. Products manufactured before that date shall be treated the same way as products that have been manufactured by entities that fall outside the scope of MiFID II product governance requirements.

How we can help

We can support you in assessing the impacts of MiFID II/MiFIR on your business and identifying the gaps. Our team of qualified professionals can also directly support or enhance your efforts to implement these requirements.

We will keep you informed of any updates regarding the MiFID II/MiFIR framework.

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