



# THE INVESTMENT ASSOCIATION

## MIFID II PRODUCT GOVERNANCE: QUALITATIVE INFORMATION REQUIREMENTS FOR THE REGULAR PRODUCT REVIEW

A PRAGMATIC GUIDE TO THE DISTRIBUTION INFORMATION REQUIRED TO  
MEET THE PRODUCT MANUFACTURERS REGULAR PRODUCT REVIEW  
OBLIGATION UNDER MIFID II AND FCA PROD RULES

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# 1. PURPOSE OF GUIDANCE



1. The Markets in Financial Instruments Directive (MiFID) II introduced the requirement for closer engagement between product manufacturers and distributors in relation to the sales process, introducing a series of product governance obligations on both manufacturers and distributors of products, including the obligation to provide each other with appropriate information to enable each party to act in the best interests of the investor.
2. The European Securities and Markets Authority (ESMA) brought these requirements together in their Final Report, entitled Guidelines on MiFID II product governance requirements (“ESMA Final Guidance”). The Financial Conduct Authority (FCA) has implemented MiFID II through its Product Intervention and Product Governance (PROD) Sourcebook with one significant difference – the requirements are applied to non-MiFID firms as Guidance which captures fund managers operating in the UK.
3. MiFID II and PROD both require that, as part of their product governance processes, product manufacturers define the target market for whom the product is compatible, for whom it is not compatible, and the distribution channels through which it is expected to be sold. Both manufacturers and distributors are required to regularly review the products they manufacturer/distribute to assess whether the product remains compatible with the intended target market and whether the chosen distribution strategy remains appropriate.
4. Distributors have the obligation to provide the information which manufacturers deem relevant to facilitate their product review. Examples of such information are given in both the ESMA Final Guidance and PROD. Both explicitly specify the expectation that sales outside the manufacturer’s target market will be reported. Both also stipulate the application of proportionality.
5. This IA Guidance, prepared with Good Conduct Consulting, has been informed by extensive discussion within an IA MiFID II Product Governance Distributor Feedback ad-hoc working group, comprising of IA members, and representatives from the Personal Investment Management and Financial Advice Association (PIMFA) and The Investing and Saving Alliance (TISA).
6. This IA Guidance sets out the range of options for engaging with distributors to obtain the necessary and relevant information for firms to discharge the ongoing product review expectations in a proportionate manner.

## This Guidance should be read in conjunction with:

- **The Joint IA and TISA Product Governance Good Practice Guide MiFID II (the Joint Product Governance Guide)<sup>1</sup>**, which sets out the broader product governance framework, such as product design, on-going product oversight, stress testing and liquidity management.
- **Good Conduct Consulting’s Target Market Population & Decision Guide<sup>2</sup>** developed through the Fund Manager, Intermediary & Distributor Working Group (FIDWG), which sets out guidance on how to define target market.


# 2. EXECUTIVE SUMMARY

7. MiFID II has resulted in a step change in the expectations of regulators with respect to the engagement of product manufacturers and distributors in ensuring investor protection.

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<sup>1</sup> [https://www.theia.org/system/files/legacy/assets/files/documents/library/2017/m1m\\_f9c\\_20170131-mifidiigoodpracticeguide.pdf](https://www.theia.org/system/files/legacy/assets/files/documents/library/2017/m1m_f9c_20170131-mifidiigoodpracticeguide.pdf)

<sup>2</sup> Available at [www.goodconductconsulting.com](http://www.goodconductconsulting.com), or directly from [steve@goodconductconsulting.com](mailto:steve@goodconductconsulting.com)

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8. A core plank of these expectations is product manufacturers obtain appropriate management information, including from distributors, to enable them to undertake a regular product review to assess whether their products continue to meet the needs of their investors, are described appropriately and are distributed to appropriate investors.
  9. However, as outlined in Appendix 5, there are significant obstacles to any mass transfer of data from distributors to product manufacturers. These include *inter alia* the level of intermediation in fund distribution, the lack of clear definition of what information is required and the format in which it should be provided, the absence of a scalable mechanism for information transfer and differing requirements across jurisdictions – both within Europe and between Europe and other regions. These challenges are sizable and unlikely to be resolved in the short-term.
  10. Whilst distributors are expected to provide information to product manufacturers, it should be noted that the purpose of this information is to enable the product manufacturer to perform the regular product review – it is not to be provided to facilitate the oversight of the distributors.
  11. The regulation does not stipulate what information product manufacturers should obtain to perform the review, it does however suggest a number of measures which should be reported. The industry has to date focused on one of these - the expectation that distributors report sales to the “negative target market”.
  12. This Guidance recognises that the regular product review requirement is intrinsically linked to the regulator’s expectations of product manufacturers in relation to good product governance. This Guidance considers from first principles what good product governance means, how this relates to the regular product review and a range of measures which may be deployed by product manufacturers to meet these expectations in a proportionate manner.
  13. Product governance is first and foremost about making decisions which are in the interests of investors. The focus of the Guidance therefore is on identifying and evaluating measures which inform product governance decision making. These include information which product manufacturers already have, together with relevant information reported by distributors under the obligation noted in para. 4. above, as well as information which may be requested from distributors.
  14. However, given the challenges summarised in para. 9. above, it is recommended that additional information is **only** requested from distributors where it materially adds to the product manufacturer’s ability to make informed product governance decisions. This recognises both that proportionality is expected to be applied by regulators and that, as noted in Appendix 5, failure to manage the volume of information requested has the potential to reduce investor choice and access over the medium to long term.
  15. It is clear from the analysis that, from a product governance evaluation perspective, considerable value may be drawn from information which is already readily available to the product manufacturer, namely complaints and flows information, together with target market exceptions mandated to be reported by distributors. Manufacturers should ensure that review of this information and any actions arising are appropriately evidenced.
  16. These measures are supplemented with distributor surveys to evaluate the product governance controls of distributors of non-mass market products, and of mass market products brought into scope on a risk-based approach. Where concerns are identified through distributor surveys or through analysis of complaints, flows or negative target market sales, targeted product-specific questionnaires completes a pragmatic framework through which product manufacturers can obtain the distribution information they need in order to meet their product review obligations in a proportionate manner.

### 3. PRODUCT TARGET MARKET CLASSIFICATION RECAP

17. In determining the information required from distributors to fulfil the regular product review requirement, in line with the principle of proportionality, consideration should be given to the nature of the product and the distribution channels through which it is recommended to be made available.

18. The industry has adopted the European MiFID Template (EMT) as the recognised industry standard for communicating the target market and recommended distribution strategy of a product to distributors. The EMT sets out in clear terms the target market and recommended distribution strategy, broken down into the categories set out in the table below.



### EMT Target Market Categories

Category	Options
Investor Type	<ul style="list-style-type: none"> <li>– Retail Investor</li> <li>– Professional Investor</li> <li>– Eligible Counterparties</li> </ul>
Knowledge & Experience	<ul style="list-style-type: none"> <li>– Basic Investor</li> <li>– Informed Investor</li> <li>– Advanced Investor</li> </ul>
Ability to Bear Losses	<ul style="list-style-type: none"> <li>– No Capital Loss</li> <li>– Limited Capital Loss</li> <li>– No Capital Guarantee</li> <li>– Loss Beyond Capital</li> </ul>
Risk Tolerance	<ul style="list-style-type: none"> <li>– PRIIPS SRI</li> <li>– UCITS SRRI</li> <li>– Internal methodology for non-UCITS/PRIIPS instruments</li> </ul>
Client Objectives & Needs	<ul style="list-style-type: none"> <li>– Return Profile (various options)</li> <li>– Time Horizon (various options)</li> <li>– Specific Investment needs</li> </ul>
Distribution Strategy	<ul style="list-style-type: none"> <li>– Execution Only</li> <li>– Execution Only w Appropriateness Assessment</li> <li>– Investment Advice</li> <li>– Portfolio Management</li> </ul>

19. In defining the population of the target market section of the EMT, each product should be assessed against each of the categories above to determine its compatibility with the needs, profile or objectives of a range of potential investors. The assessment should take account of both how the product is expected to be used and whether it has been designed specifically to meet that aspect of the target market framework outlined above.

20. In defining the population of the target market section of the EMT it is therefore useful for manufacturers to consider the following two statements:

- *The product has been designed to be compatible with end-investors whose profile, objectives and/or needs are described by the particular EMT field. **If true, the product is in the positive target market for this element of the framework, if not, test the second statement.***
- The product is incompatible with investors with such a profile, objective or need in all reasonably foreseeable circumstances. **If true, the product is in the negative target market.**

**If neither statement is true**, the product is neither in the positive or the negative target market and therefore is **Neutral**.

21. The industry recognises that, whilst target market must be defined in terms of the end investor, there is a wide range of potential investment outcomes for which a given product is compatible, contingent upon the relative exposure within the overall portfolio of investments of the investor. Therefore, certain fields can only be defined in the context of the product itself on a standalone basis, even though they may be expected to be held as part of a portfolio. These “contingent categories” – Ability to Bear Losses, Risk Tolerance and Client Objectives and Needs – inform the distributor of the range of potential outcomes for which the product manufacturer considers them to be compatible, either in the context of a portfolio or as standalone



investments, and therefore they are likely to be drawn quite broadly – i.e. it is unlikely that product manufacturers will define a negative target market for these fields.

22. The remaining “intrinsic categories” – Investor Type, Knowledge & Experience and Distribution Strategy – inform the distributor of the investor protection expectations in relation to the product, irrespective of their overall portfolio of investments. The key assessment is the level of knowledge and/or experience an investor requires in order to make an informed investment decision.
23. Whilst it is not always necessary for investors to understand the details of the investment strategy or the individual investments within an investment product, to make an informed investment decision, an investor must understand:
  - The intended outcome of the investment strategy;
  - The circumstances in which the intended outcome may not be achieved – i.e. the material risks intrinsic to the product.
24. Whilst the intended outcome of the investment strategy may be relatively easy to explain for many investment products (e.g. capital growth over the long term), the risk(s) inherent in the investment and consequently the circumstances in which a product may not achieve the outcome intended, may be harder to articulate for a mass-market retail audience. In other words, it may be easy to describe the intended outcome of certain complicated investment strategies, but be more difficult to articulate the circumstances in which they may fail to deliver the intended outcome.
25. In assessing the level of knowledge & experience required to make an informed investment decision, product manufacturer’s should consider each product against a range of factors. Below is a list of factors which product manufacturers may use as a starting point for assessing whether a retail investor fits into “basic”, “informed” or “advanced” category of Knowledge & Experience:
  - **Hard to understand investment outcomes** – i.e. products deemed by the manufacturer to be less easy to understand without background knowledge or experience in the underlying markets or the strategies;
  - **Complicated pay-out structures or breakpoints** - for example, products which only pay out if certain market conditions are met (e.g. a reference index reaches a certain threshold), or require investors to make a decision at certain points or if certain pre-determined conditions are met;
  - **Complicated investment strategies** which many retail investors may struggle to fully comprehend. For example **where the intended investment outcome is materially dependent on significant:**
    - i. **use of derivatives for investment purposes;**
    - ii. **leverage;**
    - iii. **investment in less liquid asset classes/assets** – including securities which are intrinsically thinly traded or more prone to lower liquidity in foreseeable economic circumstances.
  - **Complicated fee/cost structures** – for example complicated performance fees which many retail investors may not be able to fully comprehend from the offering documentation alone.
  - **Products that have market complexity** – for example Products that have high level of exposure to securities which may enact capital market restrictions such as China A shares, where stocks can be suspended at short notice.
  - **Regulatory focus** – products which are the focus of regulatory attention (which is likely to change over time) and likely to be as a result of one of the above criteria being met.

**Note:** products with complicated features is not synonymous with products which are deemed complex under MiFID II. There are examples of MiFID II default complex products which do not have materially complicated features and examples of non-complex products which do.
26. These factors taken together give a good indication of the level of knowledge and/or experience required for an investor to make an informed investment decision about the product in question. Different combinations of these factors may result in different conclusions by the manufacturer, consequently this assessment is by its nature qualitative, rather than quantitative; it cannot be boiled down into a mathematical calculation.

27. Furthermore, the investment protection implications of the product classification should be considered alongside the assessment of the knowledge /and experience an investor requires to make an informed investment decision. The outcome of this assessment should inform decisions regarding the compatibility of the product with the Client Types for whom it is intended, the recommended Distribution Strategy of the product and the approach to promotion of the product, as set out in the Product Governance Decision Matrix below.



**Guidance:**

It is recommended that, in setting the target market for each product, product manufacturers should assess the level of knowledge and experience required to make an informed investment decision, using the list of complicating features listed in para. 25 as a starting point.

It is further recommended that product manufacturers undertake an investor protection outcome assessment to confirm their assessment, and use the outcome of both assessments to determine the appropriate values for the intrinsic categories of the EMT target market framework. The Product Governance Decision Matrix below sets out a structure for such decision-making.

Product manufacturers should have appropriate governance around this decision process and retain evidence of the rationale behind the decision reached in each case.

**Product Governance Decision Matrix**

Knowledge & Experience Assessment	Investor Protection Outcome Assessment	Knowledge & Experience/ Client Type	Distribution Strategy Restrictions	Marketing restrictions
<p><b>Mass-Market Retail</b></p> <p>Investors with no financial industry experience or knowledge outside that provided by the regulated and authorised offering documentation and/or basic information provided at the point of sale are able to understand the product intended outcomes and the circumstances in which it may not deliver those outcomes and can therefore make an informed investment decision regarding the product</p>	<p>Product considered to be appropriate for broad availability without a suitability assessment (i.e. through execution only services with or without an appropriateness assessment).</p> <p>Broad-based mass market promotion is not considered to lead to negative investor protection outcomes.</p>	<p><b>Retail: 02010 Basic Investor</b></p>	<p>None</p>	<p>None</p>
No ↓	No ↓			
<p><b>Informed Retail</b></p> <p>Investors with either experience in investing in products with these characteristics or who have knowledge and understanding of the specific risks highlighted in the regulated and authorised offering documentation and/or basic information provided at the point of sale, are able to make an informed investment decision regarding the product</p>	<p>Product considered to be appropriate for availability without a suitability assessment (i.e. through execution only services with or without an appropriateness assessment), but to a narrower market of more informed investors.</p> <p>Targeted promotion is considered to be in the best interests of investor protection, i.e. mass promotion is not considered to be appropriate.</p>	<p><b>Retail: 02020 Informed Investor</b></p>	<p>None - still available execution only (non-complex) and execution with appropriateness test (complex), but not "in the shop window"</p>	<p>Target at informed investors - e.g. mainstream investor press etc</p>
No ↓	No ↓			
<p><b>Advanced Retail</b></p> <p>An informed investment decision can be made by:</p> <ul style="list-style-type: none"> <li>- Investors with a good knowledge and/or experience of investing in financial products, or</li> <li>- Basic/Informed investors in receipt of investment advice, or</li> <li>gaining access through a discretionary portfolio service</li> </ul>	<p>Product is considered to be appropriate for distribution to Retail Investors through services with a suitability assessment, may not be considered appropriate for availability to Retail investors without, i.e. through execution only services with or without an appropriateness assessment.</p> <p>Targeted promotion is considered to be in the best interests of investor protection, i.e. mass promotion is not considered to be appropriate.</p>	<p><b>Retail: 02030 Advanced investor</b></p>	<p>Consider restricting to exclude execution only (non-complex) and execution with appropriateness test (complex)</p>	<p>As for informed investors above</p>
No ↓	No ↓			
<p><b>Non-Retail</b></p> <p>Product not suited to Retail Investors.</p>	<p>Product not suited to Retail Investors.</p>	<p><b>Non-Retail investors only</b></p>	<p>Consider restricting to professional investors only where possible; Consider whether individual distributors are appropriate</p>	<p>Restrict marketing to professional investors</p>

### 3.1 PRODUCTS WITH COMPLICATED FEATURES:

28. Products with more complicated features, such as those outlined in para. 25, may benefit from consumer testing of the design and description both prior to launch and on a targeted basis post launch where leading indicators (e.g. complaints) might point to targeted investors not understanding the strategy, what it aims to achieve and the risks to achieving the intended outcome, and that this is properly reflected in product literature and marketing materials.
29. Such consumer testing may further inform decisions regarding the target market definition, the recommended distribution strategy and whether the product is suited to active promotion to a mass-market retail audience.

**Guidance:** It is recommended that for **products with complicated features** (including fee structures, pay-out structures and/or investment strategies) appropriate consumer testing is carried out prior to launch and on a targeted basis thereafter to ensure both that the product design is understood, the description adequately reflects the potential risks and outcomes of the product from the perspective of the intended target market, and that the target market definition is appropriate.

## 4. REGULAR PRODUCT REVIEW – PURPOSE & PROPORTIONALITY

30. Within PROD (1.1.3 G) the FCA states that good product governance should result in products that:
  - meet the needs of one or more identifiable target market;
  - are sold to clients in the target markets by appropriate distribution channels; and
  - deliver appropriate client outcomes.
31. In ensuring these principles are met manufacturers should consider, both at the design stage and as part of the ongoing assessment, **whether the product is:**
  - **Designed** appropriately to deliver the outcomes intended
  - **Described** accurately, both in product documentation for end investors and the target market definition for distributors, thus enabling it to be
  - **Distributed** through the appropriate distribution channels to compatible investors
32. These “3 Ds” form the basis for the regular review expectations, set out in MiFID II and PROD 3.2.19 R and PROD 3.2.20 G, namely that manufacturers, on a regular basis, collect appropriate management information to review their products to assess the following:
  - Compatibility of the product with the intended target market
  - Performance of distributors to assess whether the product:
    - is being distributed to the intended target market
    - being sold to those for whom it is not compatible
  - Appropriateness of the distribution strategy
33. MiFID II and PROD both recognise that the product governance rules should be applied ***proportionately***, taking into account the nature of the product and the manner in which it is sold. The assessment of measures in Appendix 3 takes this into account and, given the challenges highlighted in Appendix 5, it is recommended that information is only be requested of distributors where it is proportionate to do so and adds material product governance benefit.
34. In considering the relevance of requesting information, consideration should be given to whether such information is current. Requesting product-specific information from distributors or investors which have not undertaken meaningful transactions within the period would not be proportionate or of value to the product manufacturer’s product review process.



35. As the product review is undertaken in the interests of investor protection, it is implicit in the regulation that product manufacturers will act on the assessment of said review, therefore the outcome of the review should prompt some decision regarding whether some product governance action in relation to one or more of the 3Ds is required.

**Guidance:**

Management information requested from distributors must inform product governance decision making of the product manufacturer in relation to product design, product description/target market definition or product distribution. In applying proportionality prior to requesting information firms should evaluate whether the information materially informs product governance decisions. Information that does not inform one of these key decisions, is not relevant or necessary to meet the product governance requirements.

## 5. SUMMARY GUIDANCE

36. Appendix 3 contains detailed analysis of each measure referred to below, including an assessment of the value of each measure against the three product governance aspects – design, description and distribution. None of the measures provide direct value to the assessment of design – except product-specific questions.
37. Assessment of whether the product design is delivering as expected will be covered in the first instance by other product governance measures highlighted in the Joint Product Governance Guide (see guidance below para. 6 above), such as assessment of performance, risk and liquidity management, etc.
38. Appendix 1 sets out the measures described below into a simplified decision matrix.

### 5.1 UNIVERSAL MEASURES

39. In all instances, two measures stand out as being universal – i.e. of value irrespective of the nature of the product - flows analysis and analysis of complaints received. In addition, negative target market sales reports are of value to all products with the exception of mass market products, where there is no material negative target market to report. These measures are considered below.

**Flows (see Appendix 3.4):**

40. Flows analysis can be used to highlight unusual trends in both sales and redemptions. An unexpectedly high trend in inflows may suggest the distributors and/or investors do not understand the product sufficiently, or the distribution strategy is too broad – particularly if the flows can be tracked back to a particular distribution channel. Conversely, an unexpectedly high level of outflows may indicate that the product is not delivering against expectations and may prompt a review of the product design as well as performance against peers. Either may prompt the need for a further review of the product.

**Complaints (see Appendix 3.3):**

41. Complaints analysis about a product received either directly, or from distributors (such complaints should only be expected to be reported, or requested, where they are relevant to the product, not to the distribution), may indicate that the product description (and occasionally design) is inappropriate, or that the distribution channel is inappropriate, although this is less likely as complaints about distribution are most likely to be received directly by the distributor. Analysis of individual complaints, or a trend in complaints, should consider whether the substance of the complaint informs any aspect of product governance.

**Negative target market sales reported by distributors see Appendix 3.2.3):**

42. Distributors are required to report negative target market sales under both PROD (3.3.31 G) and ESMA Final Guidance (para. 55). Such reports are, by their nature, exceptions and should therefore each be considered on their individual merits, in a similar way to complaints, and investigated to determine whether the report, or trend in reported exceptions, has product governance implications.

**Guidance:** Information on capital flows into and out of products, complaints, and target market exceptions are generally available to product manufacturers today, either through regulatory imperative or general commercial practice. Explicitly considering the product governance implications of each is a proportionate means of gaining insight without the need to approach distributors bilaterally. It is recommended that these measures are considered for all products, irrespective product type. Manufacturers should ensure that the review of this information and any actions arising are appropriately evidenced.

43. It is notable that none of the universal measures require firms to request information from distributors – reporting of target market exceptions by distributors to manufacturers is mandatory, reporting of investor complaints related to the product should already be embedded in practice and flows data, at least for funds, is available from records readily available to the product manufacturer.

## 5.2 MASS MARKET PRODUCTS

44. As defined in the Product Governance Decision Matrix set out on page 7, for the purposes of this Guidance mass market products are defined, using the European MiFID Template (EMT) categories, as:

- Investor Type - Retail: Yes
- Knowledge & Experience - Basic Investor: Yes
- Distribution Strategy – Execution Only: Retail or Both

**Note:** A fund classified as mass market may nevertheless not have a retail share class for a variety of reasons. For example, the perceived demand for the product from retail investors may not, from the perspective of either the fund manager or the investor, economically justify the launch of a retail share class.

45. Mass retail products by definition are designed and described to be easy to understand and there is, by definition, no pattern of distribution which should be a cause for concern.

46. This aligns with ESMA’s Final Guidance (3.2 para. 50) and PROD (3.1.3 G) which both acknowledge that, “for some simpler low-risk mass-market products, the result of the firms’ assessment can be that there is no group of clients for which the product is not compatible”.

47. Given the above, this Guidance suggests that it would not be proportionate to request further information from distributors for mass market products, except where analysis of complaints or flows highlights exceptions which give cause for concern (**note:** given the target market definition, there cannot be any reportable negative target market sales). Examples of such exceptions might include:

- complaints indicating that investors have misunderstood the purpose or likely outcome of investing in a product;
- volumes of sales of a product is higher than expected, for example in a fund expected to be used for diversification.
- A high frequency of trade errors or rejected trades.

These factors may indicate that there are challenges associated with the product and its associated materials, either its description is unclear or even misleading. In this case the materials should be reviewed.

48. Notwithstanding this, firms may wish to bring some products which are defined as mass market into scope of the additional measures set out below in certain circumstances, *inter alia*:

- **Borderline target market definition:** target market definition is not always clear cut and there may be products which are borderline mass market – for example, where the assessment of “Yes” for “basic” Knowledge & Experience, may be borderline;
- **Regulatory interest:** some product types are subject to regulatory scrutiny from time-to-time, for example absolute return products;



- **Cyclical/targeted review:** firms may decide to adopt a cyclical/risk-based approach to all or a selection of mass market products;
- **Instrument utilisation:** whether changes in market conditions may result in a reason to reflect on the liquidity profile or the complexity associated with the instruments contained within it.

**Guidance:**

Mass market products are designed to meet the needs of Retail Clients with outcomes that are easily understood (e.g. classified as Basic for Knowledge & Experience in the EMT) and are therefore compatible with distribution through Execution Only channels. Consequently, it is not proportionate to request further information from distributors for mass market products, except where analysis of complaints or flows highlights exceptions which give cause for concern.

**Notes:**

- Given the target market definition, there cannot be any reportable negative target market sales).
- Firms may still, on a risk-based approach, bring distributors of certain mass market products into scope of further information requests as highlighted above.

### 5.3 NON-MASS MARKET PRODUCTS

49. Non-mass market products are defined simply as any product which is not defined as a mass-market retail product.
50. For these products, feedback from distributors may be warranted simply as there is, by definition, potential for investor detriment where such products are inappropriately purchased by investors for whom they are not intended, and who may therefore lack the knowledge and experience to make an informed investment decision.
51. Distributors are mandated to ensure that products are distributed to the appropriate target market through the appropriate distribution channel (PROD 3.3.15 R), taking account of, but not bound by, information from the product manufacturer, including target market definition (PROD 3.3.10 R).
52. Equally, distributors are mandated to undertake regular product reviews (PROD 3.3.26 R -3.3.28 R), and report information on these reviews to product manufacturers (PROD 3.3.30 R) where requested to do so by the product manufacturer (PROD 3.3.31 G(3)). It should be noted that such product reviews undertaken by distributors may be undertaken on classes or types of products, rather than product-by-product.
53. Information about the product governance arrangements at the distributor will be of significant value, both in determining whether products are likely to be distributed appropriately, and whether the distributor will have meaningful information for the product manufacturer's own review.

**Distributor surveys (see Appendix 3.5):**

54. Distributor surveys can be used to provide insight into the distributor's product governance and sales control arrangements and are therefore recommended for distributors of products not classified as compatible with "mass market" (see above). Appendix 2 sets out a sample survey which aims to enable the product manufacturer to gain assurance that the distributor has the following in place:
  - **target market process**, taking account of the product manufacturer's target market definition, and to report any sales into the negative target market
  - **regular product review process** and to escalate any instances where the distributor has concerns about the product design or has broadened/narrowed the manufacturer's distribution strategy
  - **complaints process**, including the escalation of product-related complaints to the product manufacturer
55. Where distributors confirm that they have appropriate controls in place, including escalation/reporting procedures, **where nothing is reported, it is reasonable and proportionate** for the product manufacturer to



**assume that the distributor has no concerns** with the design, description or distribution strategy of the product.

56. Where the controls are not in place, product manufacturers should review the products sold through that distributor and determine, whether further information is required either through transaction information or product-specific questionnaires (see below), and whether further action or oversight is required with respect to that distributor.

**Guidance:** Distributor surveys using questions such as those outlined in Appendix 2 are recommended as the primary means of obtaining additional product governance insight from distributors for non-mass market products, and for mass market products brought into scope on a risk-based approach as outlined above.

## 5.4 EXCEPTIONS MANAGEMENT:

57. The approach to the management of exceptions highlighted will depend on a number of factors.
58. In the first instance, product manufacturers should review the information they have available internally, for example:
- For product-related complaints, the first step may be to review the complaint against the materials associated with the product and determine whether product behaviour is outside what has been described. If yes, determine whether the product description needs to be clarified, or the product design is sub-optimal
  - For distribution related complaints and target market exceptions, an initial re-assessment of the distribution strategy may be warranted, it should be noted that target market exceptions should not be expected from discretionary managers for any products deemed compatible with Retail investors
  - For flows, an initial assessment should be undertaken to determine whether the flows can be explained by either market related factors (e.g. asset allocation sentiment or competition) or product-specific factors (e.g. price or performance)
  - For negative distributor survey responses, an initial assessment may be undertaken to determine whether the nature of the products sold, and the volumes of sales, through that distributor give cause for concern.
59. In many cases, such an assessment is likely to provide sufficient information to make appropriate product governance decisions in relation to the product design, description/target market definition and distribution strategy.

### Product-Specific Questions (See Appendix 3.6):

60. There will likely be some cases where further information is required from distributors. It is anticipated that such cases will be rare if this Guidance is adopted widely, and implemented by both product manufacturers and distributors. However, where such instance do arise, they will by their nature be product specific, relating to:
- How specific products have been sold, in what volumes and through which channels and in which investment context
  - Feedback on any concerns regarding the description or target market of the product, or even any feedback on the product design rising from the distributor's own regular product review
61. Such follow-up information requests are likely to require a mix of quantitative (for example volume of sales and exceptions) and qualitative (for example rationale for exceptions). It is suggested that this follow-up request is best achieved through product-specific questions covering both qualitative and quantitative aspects. **Note:** It should be acknowledged that, as a follow-up of other product governance review activities, data obtained through the product specific questionnaire is unlikely to align with the regular product review



cycle. Consequently, each product specific questionnaire needs to be considered on its own merits to determine whether there are any product governance concerns.

62. It should be noted that in certain cases distributor surveys, where undertaken, may provide sufficient information without the need for follow-up product-specific questions – for example, where the information provided through the distributor survey indicates that robust product governance and escalation processes are in place.
63. Having obtained the necessary information to draw product governance conclusions, product manufacturers should determine whether or not there are any product governance decisions to make – namely changes required to the product design, description, target market or distribution strategy.

**Guidance:** irrespective of the type of the distribution information used to form the initial view, firms must put in place an exceptions management process to investigate any anomalies using internally available information and, where appropriate, information from the distributor.

Having investigated fully, firms should then determine whether or not there is a need to make a change to the product design, product description or product distribution arrangements. In either case, the decision should be fully documented and evidenced.

## 6. RECORDKEEPING AND FREQUENCY OF REVIEW

64. Whilst there are no recordkeeping requirements stipulated in PROD or MiFID it is recommended that firms maintain records for a minimum of 3 years. This aligns with the recordkeeping requirements for suitability assessments which do not relate to pensions or life policies.
65. Similarly, regulation requires that product manufacturers “regularly review” their products but does not stipulate a timeframe for such review. Clearly, some of the measures suggested in this Guidance lend themselves to more frequent review than others. Individual firms must determine the frequency of review for individual products, but it is important to note that this may be different from the frequency of review of some of the measures considered in this Guidance. For example, complaints and flows analysis may be reviewed for any potential product governance implications on a monthly or quarterly basis in line with the firm’s existing practices. Other measures which are based on direct information requests to distributors may be annual or should be at least as frequent as the product review itself, if less frequent than annual.

## 7. CONCLUSION

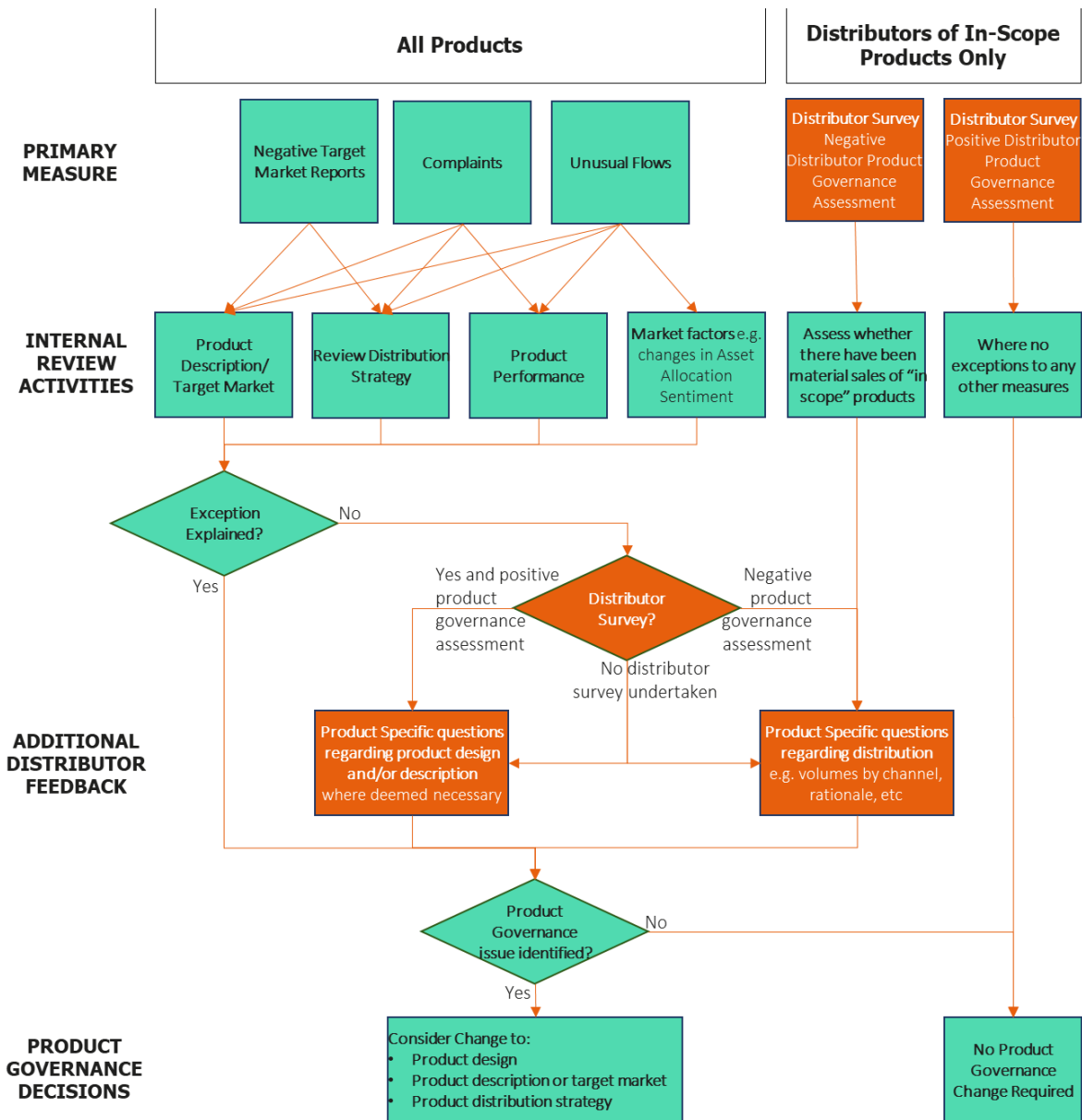
66. In conclusion, there are a series of measures which can be both highly effective in informing the product manufacturer’s product governance requirements and implemented at little cost either financially or in terms of effort – both to the product manufacturer and the distributor.
67. Complaints and flows analysis, which are already embedded in the processes of most product manufacturers, can with little effort be extended to provide meaningful insight without any information request of distributors. Similarly, a review process akin to that already in place for complaints can be implemented by product manufacturers to analyse any reports of sales into the negative target market. This should be sufficient to oversee the majority of “mass market” products, with any exceptions being investigated using the guidelines set out above.
68. In addition to this, for the distributors of non-mass market products, together with any mass market products brought in scope on a risk-basis (see para. 48), it is recommended that firms implement a process of distributor surveys. These surveys, based around a short series of questions about the distributor’s product governance arrangements (see Appendix 2), aim to determine whether distributors have the processes to identify and escalate any areas of product governance concern to the product manufacturer.
69. It is reasonable and proportionate for product manufacturers to assume that, in the absence of reports to the contrary, distributors which have robust product governance arrangements in place should be of no concern

regarding any of the products they distribute for the product manufacturer and would be expected to have acted in accordance with the product manufacturer's target market definition and recommended distribution strategy.



70. Conversely, where issues are identified with a distributor's product governance arrangements, product manufacturers could review the types of products sold by that distributor, and for significant sales of non-mass market products, further product-specific questions could be asked as a follow-up, additional to any other distributor oversight processes that are in place.

# APPENDIX 1: SIMPLIFIED PRODUCT GOVERNANCE DECISION MATRIX



**Notes:**

1. In-scope distributors means those distributors which distribute non-mass market products and any products defined by the distributor as being in scope of distributor surveys
2. Expectation is that only a small minority of products will fall within the "in scope" definition
3. Expectation is that most exceptions will be explained by the internal review activities, therefore additional feedback from distributors is expected to be a relatively rare event

## APPENDIX 2: DISTRIBUTOR SURVEY SAMPLE QUESTIONS



### Sample Distributor Survey Request

**Requestor:** [product manufacturer]

**Distributor:** [distributor name]

**Reporting Period:** From: [from date] To: [to date]

Ref	Question	Option
1	<p>Do you have a target market/product approval process which considers which products are compatible with distribution through which type of distribution channel, taking account of the types of investors in each?</p> <ul style="list-style-type: none"> <li>• If no, please explain how you ensure that products are appropriate for your investors.</li> <li>• If yes, please provide brief details of your process</li> </ul>	Y/N
2	<p>Do you have a regular product review process in place to assess each product offered through each of your distribution channels on a periodic basis to determine whether it remains compatible with the client base for that distribution channel?</p>	Y/N
3	<p><i>If answer to question 1 and/or question 2 is "Yes"</i>                      Does your product approval and/or product review process take account of the product manufacturer's target market assessment and recommended distribution strategy (where provided) for each product? If no, please explain.</p>	Y/N
4a	<p><i>If answer to question 3 is "Yes"</i>                      Do you have controls in place to prevent the sale of products:</p> <ul style="list-style-type: none"> <li>• to the types of clients the product manufacturer does not intend them to be sold to (i.e. to the negative target market)?</li> <li>• through distribution channels the product manufacturer does not recommend?</li> </ul> <p>If Yes, provide brief details.</p>	Y/N
4b	<p><i>If answer to question 3 is "Yes"</i>                      Do you ever <b>deliberately</b>:</p> <ul style="list-style-type: none"> <li>• offer the product to clients not intended by the product manufacturer (i.e. widen the target market)?</li> <li>• Offer products through distribution channel not recommended by the product manufacturer (i.e. broaden the distribution strategy)?</li> <li>• Restrict the availability of a product for some of your clients (for example from investors with "basic" knowledge) for whom the manufacturer has deemed the product compatible (i.e. narrow the target market)?</li> <li>• Restrict a product from some of your distribution channels which are permitted in the product manufacturer's recommended distribution strategy (i.e. narrow the distribution strategy)?</li> </ul>	Y/N
5	<p><i>If answer to question 4a is "No" or 4b is "Yes"</i>                      Do you have a process in place to <b>automatically report</b> – i.e. without request from – the product manufacturer:</p> <ul style="list-style-type: none"> <li>• Sales to the types of clients the product manufacturer does not intend them to be sold to (i.e. to the negative target market)?</li> <li>• Sales through distribution channels the product manufacturer does not recommend?</li> <li>• Instances where you:                             <ul style="list-style-type: none"> <li>• have widened or narrowed the product manufacturer's target market or distribution strategy?</li> <li>• Deem the product manufacturer's target market or distribution strategy to be potentially incorrect?</li> </ul> </li> </ul>	Y/N





	If yes, please provide brief details.	
6	<i>If answer to question 4b is "Yes" and 5 is "No"</i> Please provide details for any of our products where you widened or narrowed the target market or recommended distribution strategy, or where you believe the target market or recommended distribution strategy for any of our products is incorrect, including a rationale for each case.	
7	Do you have a process for <b>automatically reporting</b> complaints or patterns of complaints which may indicate an issue with a product to the product manufacturer. If no, please provide details of any complaints or patterns of complaints relevant to our products.	Y/N

## APPENDIX 3: EVALUATION OF DISTRIBUTOR INFORMATION OPTIONS



### A3.1 DISTRIBUTION INFORMATION MEASURE EVALUATION APPROACH

71. Neither ESMA nor the FCA provide any guidance to the manufacturer on what appropriate management information may be. However, under the regulation MiFID and FCA authorised distributors are mandated to provide manufacturers with the information the manufacturer needs in order to fulfil their ongoing product review obligations. PROD 3.3.30R and 3.3.31G suggest a non-exclusive list of examples including:
- sales information – which should include information on any sales made outside the target market;
  - summary information of the types of clients;
  - a summary of complaints received;
  - responses from clients to questions suggested by the manufacturer for the purposes of obtaining feedback from a client sample;
  - Information on the product reviews carried out by the distributor, where requested by the product manufacturer
72. In addition, the Joint Product Governance Guide recommends a number of measures which may be relevant to the regular review requirement, some of which are also referred to in the regulation. These include:
- Complaints analysis;
  - Flows analysis; and
  - Distributor Surveys (referred to in the Joint Product Governance Guide as distributor due diligence)
73. Appendix 1 of this Guidance assesses the following measures drawn from those highlighted in paragraphs 71 and 72 above:
- Target Market Exceptions
  - Inflows/Outflows analysis
  - Complaints analysis
  - Distributor surveys
  - Product specific questions (including the results of the distributor’s own assessment)
74. Each measure is assessed for its value against each of the principles of good product governance, as outlined in paragraphs 30. and 31. above:
- **Product Design** – does the measure provide any insight into whether the product is designed appropriately to deliver the outcomes intended?
  - **Product Description** – does the measure inform whether the product description or target market definition is appropriate?
  - **Product Distribution** – does the measure evidence that the product is distributed to those for whom it is intended, and crucially, those for whom it is not
75. To aid the assessment of each measure, two notional product types are considered:
- **Mass Market fund** – A non-complex fund aimed to meet the needs of a wide range of investors, including mass retail investors with “basic” Knowledge & Experience, sold through all distribution channels.
  - **Non-Mass Market fund** – i.e. a product which is not designed to be compatible with mass market – in other words, not designed to be compatible with Retail investors with “basic” Knowledge & Experience and may be further restricted in terms of Client Type or Distribution Strategy.

## A3.2 TARGET MARKET EXCEPTIONS REPORTING



### A3.2.1 AVAILABLE INFORMATION

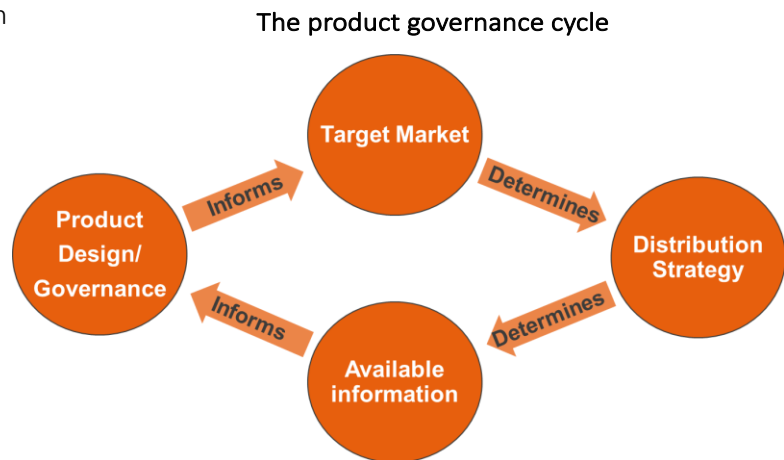
76. Distributors are mandated to provide information on sales to the negative target market. However, it is important to recognise that different types of distributor have different levels of information available to them – for example the information about the end investor buying non-complex instruments through an execution-only platform will be limited to their client type – i.e. are they a retail, professional or eligible counterparty investor. The platform will have no information on their knowledge & experience, attitude to loss or risk, or their investment objectives. Additionally, the platform may not have a full view of the portfolio of investments that a client may have.

**Target Market Information theoretically available through different Distribution Channels**

Target Market Aspect	Distribution Strategy:			
	Execution Only	XO w/Appropriateness	Investment Advice	Portfolio Management
- Client type	Yes	Yes	Yes	Yes
- Knowledge & Experience	No	Yes (Instrument Specific)	Yes	Yes
- Ability to Bear Losses	No	No	Yes	Yes
- Attitude to Risk	No	No	Yes	Yes
- Client Objectives & Needs	No	No	Yes	Yes

77. Even where some distributors have greater levels of information in relation to the end investors' attitude to loss and risk, and their investment objectives, it is of limited value for the following reasons:

- First, in practice the product design informs the target market, which in turn determines the distribution strategy which in turn informs the information available via the distribution channel (see the product governance cycle diagram). In other words, as part of the distribution strategy determination, product manufacturers have already determined whether investors require the additional investor protection provided by availability only through channels which require a suitability assessment. Where this is not the case, information on these fields is structurally unavailable from execution only channels.
- Secondly, where this information is collected by the distributor, it is for a different purpose - to meet the suitability/appropriateness assessment obligations of the distributor in relation to specific individual requirements. Target market on the other hand, is designed to define general groups of investors for whom the product is compatible. ESMA guidance acknowledges that diversification plays a key role in investor outcomes and therefore from a reporting perspective, these categories would only be of value in the context of the overall investment portfolio and the role of the specific product within it. This information is not available to the manufacturer through quantitative transaction data from distributors.
- Thirdly, the purpose of the ongoing review is to fulfil product governance obligations, not general distributor oversight or to check distributor compliance with suitability/appropriateness obligations. Whilst distributor oversight is undoubtedly of value in the wider context (and required under different national regulations), there are more pragmatic means of achieving this, as set out under distributor surveys below.



**Guidance:** It is recommended that **only Client Type and Distribution Channel is required from distributors** when reporting negative target market transactions. This information could be in summary or transaction-based form, and should ideally be reported using an industry standard, such as the TISA/PIMFA template or its successor.



### A3.2.2 STRUCTURAL PROPORTIONALITY

78. Some types of investor do not purchase through a MiFID service, i.e. via a distributor, they purchase directly on their own account. In these instances, no negative target market sales reporting should be expected, simply as they invested directly. Highlighted below are shareholders which, for the purposes of reporting negative target market sales, are not distributors.

#### Own Account Investors:

79. Own account investors are defined as investors investing their own assets or assets on behalf of another product. Examples include corporate investors and Financial Services investors – for example Life companies investing their own balance sheet assets – including those which match unit-linked policies – in this instance the financial institution is the investor in, not the distributor of, the product.

#### Third party products (Product Manufacturer in their own right):

80. Similarly, a financial institution may invest in a product as part of their own product offering, for example a fund-of-funds. In this instance, the institution becomes a product manufacturer in its own right, breaking the distribution chain from the first product manufacturer. The fund-of-funds in this instance is the end investor for the purposes of the manufacturer’s product governance process.

81. In both these examples, distribution feedback should not be expected, as the entity is in effect the end-client, rather than a distributor providing product access to end-clients. This does not mean, of course, that such holders do not have valuable information in relation to the Description and Design of the product.

### A3.2.3 EXCEPTIONS TO TARGET MARKET EVALUATION

82. Exceptions to target market, i.e. summary or individual transaction data on sales into the negative target market, subject to mandatory reporting by distributors under PROD 3.3.30R.

Product Review Aspect	Evaluation
Product Design	Sales exceptions in relation to target market reported by the distributor are of little product governance value when assessing whether the product is appropriately designed to deliver the outcomes set out in the product’s documentation.
Product Description	More likely such feedback may indicate misalignment between the product description/target market definition and design.
Product Distribution	Similarly, where exceptions are widespread across distributors and follow-up reveals a lack of understanding about the purpose of a given product the follow-up may reveal implications for distribution strategy.

#### Primary value:

83. The primary product governance value of target market exceptions reported by the distributor is as an indicator of potential areas of concern. Product manufacturers should consider whether such reports warrant further investigation with the reporting distributor, taking account of proportionality and an assessment of the risk to the end investor implied by such reports.

84. Further investigations are likely to be a mix of qualitative and quantitative, for example a request for an explanation of the rationale for such sales together with a quantitative assessment of the total sales by distribution channel and client type to enable an evaluation of the context of the sales.

**Drawbacks:**

- 85. Whilst there is no mechanism for the mass transfer of information from distributors to product manufacturers (see Appendix 5), there is a concern that such exceptions may not be reliably reported. Additionally, anecdotal feedback suggests that such instances will be rare in both number and value.
- 86. Finally, target market exceptions do not meet the product governance information requirements in their entirety – follow-up questions in relation to the reporting distributor are required to gain meaningful product governance insight.

**Overall assessment:**

- 87. Both ESMA’s Final Guidance and PROD, stipulate that distributors should report sales into the negative target market. However, as noted above exceptions are by their nature ad hoc – they may (or may not) occur – and therefore cannot be considered a reliable data source for product governance purposes.
- 88. In other words, the absence of a report does not necessarily indicate that there is no cause for concern but requesting confirmation of such is likely to be disproportionate, compared with alternatives such as distributor surveys (see below).

**Guidance:** Whilst target market exceptions are expected to be rare and therefore trends are unlikely to be a reliable leading indicator, individual reports should be explicitly reviewed for product governance implications, with a periodic review of all reports over a period to identify any trends. It is recommended that this approach is implemented for all products, noting that such reports are unlikely to be received for mass market products where, by definition, there cannot be a material negative target market. Where such information is provided by distributors the Investment Association supports the use of a standard industry template is used, such as the TISA/PIMFA template.

**A3.3 COMPLAINTS ANALYSIS**

- 89. Analysis of complaints received directly by the product manufacturer or referred by distributors. These complaints should be in relation to the product itself, rather than the distribution of the product, as complaints regarding distribution will be reported to and are the responsibility of the distributor themselves, and therefore of little product governance value, unless the distributor identifies a concern regarding the distribution strategy.

Product Review Aspect	Evaluation
<b>Product Design</b>	Complaints about the product received either directly, or from the distributors, similarly to high levels of outflows, may indicate that the product design or description is inappropriate. Whilst there will be instances where a product has a significant trend in complaints, this is the exception rather than the rule. Consequently, from a product governance perspective, information is likely to be mainly derived from the analysis of the individual complaints rather than the trend.
<b>Product Description</b>	
<b>Product Distribution</b>	Complaints about distribution are unlikely to be passed from distributor to manufacturer as the distributor will have the obligation to resolve these themselves. Additionally, there is little value in their analysis from a product governance point of view, unless a distributor identifies a concern regarding the distribution strategy.

**Primary value:**

- 90. As existing analysis not requiring a further request from the distributor and as a supporting indicator of product governance health; may be a leading indicator in those (relatively rare) instances where a dominant trend is identified, and in any case individual complaints may provide insight into design issues, and more particularly, product description.

### Drawbacks:

91. The key drawback is that, in the context of the number of unitholders, the number of complaints is typically extremely low and ad hoc. It is therefore relatively unusual for complaints to develop into a meaningful trend from a product governance perspective.



### Overall assessment:

92. Manufacturers are already required to have a process in place to manage complaints received either directly or from distributors. Analysis of such complaints should therefore already be being undertaken and any findings of relevance should be fed into the product governance process.

**Guidance:** Whilst complaints analysis trends are not always a conclusive leading indicator, analysis of an individual complaint, or group of complaints, should be explicitly reviewed for product governance implications as part of the resolution process, with a periodic review of complaints by product to identify any trends. It is recommended that this approach is implemented for all products.

## A3.4 FLOWS ANALYSIS

93. Analysis of the overall trends in inflows and outflows at a product level, using information from the shareholder register, appropriately tagged with distribution channel and client type, where possible.

Product Review Aspect	Evaluation
Product Design	High level analysis of inflows and outflows, unlike sales data, provides a trend of redemptions as well as sales of a product. A significant trend in outflows - for example complete redemption by an advisor or portfolio manager - may indicate that the product is not delivering against expectations and may prompt a review of the product design as well as performance against peers.
Product Description	A high trend in inflows, particularly if through analysis of the shareholder register the manufacturer is able to identify if it is coming through a particular channel type, may for certain products:
Product Distribution	<ul style="list-style-type: none"><li>• be an indicator that investors (or distributors) do not fully understand the nature of the product; and/or</li><li>• where the product description is deemed to be clear, indicate that the distribution strategy for the product is too broad.</li></ul>

### Primary value:

94. As an ongoing indicator in all product governance decision types, with the benefit that the information is available without requiring additional reporting from the distributor. This is particularly true where entries on the shareholder register can be “tagged” with client type and distribution channel. For example, an Independent Financial Advisor dealing exclusively with Retail Clients and providing only Advice (i.e. not Execution Only or Portfolio Management) can be tagged as such from the shareholder register without seeking additional reporting from the distributor.

### Drawbacks:

95. A key drawback is that the level of intermediation on many funds means that a review of the shareholder register may not provide a clear enough picture of distribution patterns to draw conclusions.
96. However, many intermediaries provide substantial information on their sub-distribution arrangements and a careful analysis of this information, undertaken periodically, may allow the manufacturer to make assumptions about the overall distribution. This, on a best efforts’ basis, enables them to draw conclusions which may be the basis of further analysis.

### Overall assessment:

97. Flows trend analysis is likely to be already undertaken by most manufacturers from a commercial perspective. Extending the use of such analysis provides valuable information in all aspects of product governance with minimal additional effort.



**Guidance:** Anomalies identified from analysis of capital flows into and out of products provide a useful indicator for potentially all aspects of product governance. Conversely, the absence of any anomalies provides significant comfort that distributors and investors have not identified any concerns with the product in question. Typically firms already have in place flows analysis for commercial purposes, so the cost and effort to extend the remit of such analysis to consider whether anomalies indicate any potential product governance concerns is low. **It is recommended that analysis of flows from a product governance perspective is implemented across all products as an ongoing indicator of product governance health.**

### A3.5 DISTRIBUTOR SURVEYS

98. Initial and ongoing assessment of a distributor’s product governance arrangements, typically undertaken through a request of the distributor to complete a questionnaire.

Product Review Aspect	Evaluation
<b>Product Design</b>	Distributor surveys do not directly inform the design or description of individual products, but rather focuses on the processes the distributor has in place to evaluate the products themselves and reporting back to the manufacturer if there are any concerns. For example, where a distributor has its own product review process in place, a clear process for target market, and has a mechanism for reporting exceptions to the product manufacturer of either, the product manufacturer can reasonably assume that unless they are advised otherwise, there are no material concerns regarding their products.
<b>Product Description</b>	
<b>Product Distribution</b>	Whilst the product governance requirements do not explicitly require manufacturers to oversee distributors – distribution is not an outsourced function in the UK (unlike Luxembourg for example) – an evaluation of the distributor’s own product governance arrangements enables product manufacturer’s to determine whether deviations from their target market definition are permitted, whether the distributor has processes to identify any concerns with the products it distributes, and has appropriate mechanisms to automatically report exceptions. Additionally, such an assessment would naturally inform the decision-making process when selecting distributors for restricted distribution products.

**Primary value:**

99. The approach enables the manufacturer to identify which distributors have good product governance controls and which could be improved. This enables the application of proportionality at the distributor level through a single, general engagement, rather than on a specific product-by-product basis.

100. For example, where the product governance assessment is positive, reliance on the distributor to ensure that a product is distributed to the appropriate target market passes the reasonable steps test set out in PROD 3.2.1R. Manufacturers can therefore focus their product-specific additional information requests on those distributors where controls are less positively assessed, reducing the overall volume of data requested to fulfil their product governance obligations.

101. Distributor surveys are of particular relevance for products which are not considered to be suited to mass-market retail investors, as the product manufacturer is reliant on the distributors to ensure the product reaches the appropriate investor audience. Such controls are less relevant for mass market products, which by definition have no meaningful negative target market and are easy to understand.

102. Notwithstanding this, firms may wish to bring some products which are defined as mass market (i.e. distributed through any channel to retail clients with basic knowledge & experience) into scope of the additional measures set out below in certain circumstances, *inter alia*:



- **Borderline target market definition:** target market definition is not always clear cut and there may be products which are borderline mass retail;
- **Regulatory interest:** some product types are subject to regulatory scrutiny from time-to-time, for example absolute return products;
- **Instrument utilisation:** whether changes in market conditions may result in a reason to reflect on the liquidity profile or the complexity associated with the instruments contained within it;
- **Cyclical/targeted review:** firms may decide to adopt a cyclical/risk-based approach to all or a selection of mass market products. In addition, product governance questions can be standardised (see Appendix 2 for sample questions) and combined with other regulatory expectations. For example, the ongoing oversight of financial crime arrangements of distributors where reliance is being placed on their customer due diligence processes.

103. Distributor surveys covering the product governance controls of the distributor also informs the selection and ongoing oversight of distributors of higher risk or targeted products.

#### **Drawbacks:**

104. The major drawback is that the process is distributor not product based, and therefore does not provide information at a product level. It does however enable manufacturers to identify which distributors should be a focus for further investigation.

#### **Overall assessment:**

105. Distributor surveys can provide meaningful insight into product governance arrangements of distributors in relation to their target market related distribution controls, product review, and exception escalation to the product manufacturer.

106. For distributors assessed as having strong product governance arrangements, in the absence of any escalation reports, it is reasonable for the product manufacturer to assume that there are no concerns to be reported by that distributor in relation to any of the products it distributes.

107. Equally, where a potential product governance concern is identified independently, for example through analysis of inflows and outflows, distributors with strong product governance controls are likely to be best placed to provide independent insight.

108. Conversely, it would be proportionate to focus product-specific information requests on non-mass market products sold through distributors with sub-optimal product governance arrangements to determine whether the distribution strategy in general and in specific cases remains appropriate.

**Guidance:** Distributor surveys should be considered as the primary additional product governance measure for non-mass market products, and any products nominally categorised as mass market products, but which are perhaps borderline, subject to regulatory interest or as part of a broader cyclical product review process. The assessment of the distributor survey response should inform whether further product-specific questions may be appropriate, or whether the absence of any reporting from the distributor indicates that they have no material concerns with the products it distributes on behalf of the product manufacturer. Additionally, distributor surveys can inform the selection of distributors where the product manufacturer has identified that a higher level of product governance control is critical to ensuring a product is appropriately distributed.



## A3.6 PRODUCT-SPECIFIC QUESTIONS

109. A specific set of questions relating to a particular product (or set of products) from all or some of the distributors distributing the product, including the results of the distributor’s own product reviews, as mandated in PROD 3.3.26R to PROD 3.3.28R



Product Review Aspect	Evaluation
Product Design	Highly valuable information, if required to investigate areas of concern, enabling the manufacturer to explore how the product is used and therefore whether it is being used as intended/designed.
Product Description	Enables a manufacturer to explore whether the product has been described appropriately, where a concern is has been identified in this regard. For example, if a product is used in an inappropriate way, it may indicate that the product description is inappropriate.
Product Distribution	The manufacturer, if required, can through this method explore in greater detail how the product is distributed by the distributor. This can include both qualitative information, for example the rationale for the sales strategy deployed for the specific product and quantitative, i.e. the volumes being sold to which type of investors through which channel.

### Primary value:

110. The approach provides output which is information rich, enabling the manufacturer to gain comprehensive information from the distributors selected to respond, including their own internal assessments, on every aspect of product governance, both qualitatively and quantitatively.

111. The product-specific questions will need to cover both quantitative aspects (such as number and value of exceptions and overall sales) and qualitative aspects (such as rationale for exceptions or for deviating from the product manufacturer’s target market definition or distribution strategy).

### Drawbacks:

112. The approach is non-scalable as each distributor will need to complete such a survey for each product/group of products it distributes, for each product manufacturer, which would be a disproportionate burden for distributors and limit the degree to which answers for this could be collected reliably and speedily.

### Overall assessment:

113. Product-specific questions are, by their nature, tailored to the needs of the manufacturer and therefore should provide the insight a product manufacturer would need for a given product, albeit at a high level of effort for both the distributor and the manufacturer.

114. However, when used on a follow-up basis, to further investigate areas of concern highlighted by flows, complaints, negative target market reports or distributor surveys, product-specific questionnaires can be highly targeted to ensure that they are both impactful and of material value, as well as proportionately applied. It should be acknowledged that, as a follow-up of other product governance review activities, data obtained through the product specific questionnaire is unlikely to align with the regular product review cycle. Consequently, each product specific questionnaire needs to be considered on its own merits to determine whether there are any product governance concerns.

115. Follow-up on complaints, negative target market reporting and distributor surveys will clearly focus on the distributor linked to the issue highlighted. However, for unusual trends highlighted through the flows analysis of a particular product, it would be reasonable to apply proportionality and target any follow-up product-specific questions on a representative sample of distributors, based on materiality of the flows.

**Guidance:** Distributors that have wide product/product provider ranges (especially smaller firms) are likely to find responding to product-specific data requests from manufacturers very resource-intensive, unless such requests are highly focused.

Consequently, the approach should be used proportionately where it will add material product governance value – for example to investigate material concerns highlighted by complaints & flows analysis, target market exception reporting or distributor surveys.



## APPENDIX 4: THE REGULATORY CASE FOR PROPORTIONALITY



116. The expectation that the product governance requirements will be applied proportionately is spelled out explicitly in Recital 18 of the MiFID Delegated Directive EU2017/593 which states that “rules may be applied in a proportionate manner...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”. This is echoed in PROD 3.1.2 R and 3.1.3 G. In addition, proportionate language is used throughout both documents – of particular note are those highlighted below.
117. More specifically in relation to distribution information reporting, under the ESMA Final Guidance, whilst the requirement to report sales into the negative target market is worded in absolute terms (3.4.3 para. 55: “sales of products into the negative target market should always be reported...”), the Final Guidance clarifies in para. 69 the importance of taking into account proportionality, and in para. 74 notes that such reports should be made where “relevant to the product governance process of the manufacturer”.
118. PROD similarly notes in 3.2.1 R that product providers should take “reasonable steps to ensure that the financial instrument is distributed to the identified target market” and to assess (3.2.19 R) whether the product is “reaching clients for whose needs, characteristics and objectives the financial instrument is not compatible”. To discharge this responsibility, product manufacturers should “should collect and analyse appropriate management information to detect patterns in distribution as compared with the planned target market in order to assess the performance of the distribution channels through which a financial instrument is being distributed”.
119. PROD 3.3.30 R and 3.3.31 G note that distributors “must provide to the manufacturer of each financial instrument it distributes” information to support their product reviews, specifically to “check that it remains consistent with ... the [manufacturer’s] target market”. Specifically referenced is “information on sales” to include information on sales made outside the target market”. The Guidance further clarifies that the data provided should be “necessary for the manufacturer to review the financial instrument” and that “relevant information could include summary information on the types of clients”, amongst other things.
120. In order to apply proportionality, the following need to be clarified:
- What constitutes “relevant and necessary” information for manufacturers to undertake their product reviews?
  - What precisely is the meant by not compatible and sales made outside the manufacturer’s target market
  - What constitutes reasonable steps in collecting and analysing the information to assess whether the product is being sold to the intended target market and not to those for whom it is not compatible
121. The IA MiFID II Product Governance Distributor Feedback Ad-hoc Working Group has concluded the following definitions:
- Relevant and Necessary information – is defined as information which provides meaningful insight to the manufacturer from a product governance and/or an investor protection perspective, taking account of both the nature of the product and the service through which it was acquired.
  - Sales made outside target market – is defined as sales to an identifiable type/group of investors for whom the product is fundamentally incompatible to their needs, characteristics or objectives

This definition is consistent with para. 71 of the Final Guidance which defines negative target market as “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” and also aligns closely to PROD 3.2.8 R which requires product providers to identify “any group or groups of client for whose needs, characteristics and objectives the financial instrument is not compatible”.



- Reasonable steps to collect means that product manufacturers will make reasonable efforts to obtain, where possible, the information from distributors necessary to undertake their product review. Product manufacturers may take into account proportionality when determining the level of effort expended in securing this information, including information they may already have which may supplement, or negate the need for, further information requests. This recognises that product manufacturers are dependent on distributors to deliver the information and will, in many cases, have no direct relationship with the distributor.

**Guidance:** Taking account of other sources of information that may be available to them, manufacturers' obligations to obtain data from distributors can be summarised as: *“product providers must make reasonable efforts to obtain from distributors relevant information necessary to assess whether the product’s design, target market definition and distribution strategy remain appropriate and whether it is being sold to the intended target market and not to those for whom it is not compatible”*.

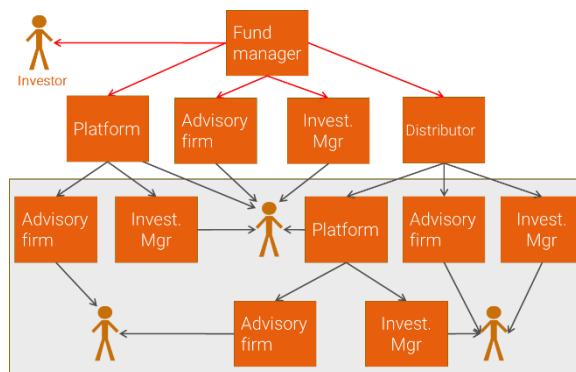
## APPENDIX 5: THE BUSINESS CASE FOR PROPORTIONALITY



### A5.1. INDUSTRY BACKDROP

122. To date, the industry approach to addressing the distributor reporting expectation has focused on sales into the negative target market, as explicitly called out in paragraph 55 of the ESMA Final Guidance. However, for the funds industry in particular, this presents a number of challenges.

123. Whilst product manufacturers have contractual relationships with some distributors, those contractual relationships are often with intermediaries rather than distributors who have the direct relationship with the end-investor. This reflects the fact that the investment services industry across Europe, but particularly in the UK, is heavily intermediated. Additionally, it is the nature of the vast majority of funds that they are open to investment directly – there is no requirement to have a direct relationship with distributors, particularly post-Retail Distribution Review (RDR) in the UK.



124. Putting this in to context, as an industry example, one firm has c. 12,000 identifiable distributors across the shareholder registers of its European-based management companies, but only around 3,000 distribution agreements between those management companies and distributors. This same company, at the time had around 1,000 fund ISINs (i.e. products) in distribution across these management companies, and a total of 28,000 combinations of distributor and product, at the share register level.

125. However, these figures are not reflective of how the products are actually sold due to intermediation. In most cases, the assets acquired through intermediary distribution appear as a single entry on the share register of the fund. In a heavily intermediated market such as Europe, and the UK in particular, this means that the number of distributors for a particular fund can easily reach the thousands.

### A5.2. IMPLICATIONS FOR DISTRIBUTORS

126. For many distributors, the explicit product governance expectations, and in particular the expectation of reporting of information back to the manufacturer, are new.

127. There are also a number of factors which are inhibiting distributors from providing negative target market reports independently to product manufacturers in line with regulatory expectation.

- The first is that there is no agreed reporting standard. Whilst some countries have developed standards, notably the UK through the TISA/PIMFA template, no pan-European standard has yet emerged. With many funds being distributed internationally, and many distributors sourcing their funds from multiple jurisdictions, this represents a significant challenge.
- Secondly, different jurisdictions across Europe have adopted different approaches. Most funds are governed by UCITS or AIFMD and therefore fall outside the scope of MiFID. Whilst under FCA PROD provisions, the requirements apply as guidance in the UK, and ESMA indicated that it considered the provisions to represent best practice, other jurisdictions have not followed the FCA's lead. Consequently, the requirement to provide information from distributors to manufacturers is not seen to apply to funds in some EU jurisdictions.
- Finally, whilst product manufacturers have mechanisms to transmit fund information to distributors, through a myriad of data vendors using the European MiFID Template (EMT)<sup>3</sup>, there are no established

<sup>3</sup> [www.findatex.eu](http://www.findatex.eu)

mechanisms to transmit information from distributors back to product manufacturers – such communications are currently manual and bilateral in nature.



### A5.3. THE INFORMATION CHALLENGE

128. As a consequence of the above, there are a number of challenges to obtaining appropriate product governance information from distributors. These are considered below.

#### A5.3.1 STRATEGIC

129. The transfer of significant quantities of data between distributors and product manufacturers, particularly where there is no scalable infrastructure in place to do so, comes at a significant cost. If this cost is too high, then there is a risk that firms – both distributors and manufacturers – will rationalise those relationships to cut costs, and in the process reduce consumer choice and/or raise the barriers to investing for the end consumer.

#### A5.3.2 OPERATIONAL

130. From an operational standpoint, there is little likelihood that product manufacturers will receive universal and statistically useful sales data – at least in the short term - given the industry challenges outlined above. This will result in significant data gaps – particularly where funds are distributed either by distributors with no relationship with the manufacturer, as is the case for much UK distribution, but also where funds are distributed cross-border – particularly outside Europe, for example in Asia or Latin America, where the expectation may be unknown.

131. In addition, pure data reporting presents a number of challenges. The first is identifying what is meaningful. As noted above, without the application of proportionality a fund manager may have hundreds of thousands or even millions of potential data points to collect and analyse, notwithstanding the data gaps.

132. Further, without a pervasive trend which may be self-explanatory, the analysis is only useful if it is accompanied by an explanation which enables the fund manager to determine a course of action. The numbers on their own are not meaningful, particularly if the report is solely on sales outside target market. Context is required to facilitate sound product governance decisions by product manufacturers.

133. Finally, transaction-based reporting provides only part of the information required to undertake the regular product review. Purely quantitative information is insufficient to inform product governance decision-making.

### A5.4. PROPORTIONALITY

134. A proportionate approach to distributor provision of product governance information is therefore required to enable product manufacturers to not only target the acquisition of relevant information, but also to facilitate meaningful analysis and the ability to make appropriate decisions.

135. The funds industry is well regulated, with the majority of funds covered by one of two well established regulatory frameworks – UCITS and AIFMD. Both have extensive product governance requirements, and typically fund management companies will already have well embedded product governance controls in place.

136. A proportionate approach to distributor information must therefore ensure that any incremental effort on the part of both product manufacturers and distributors, must also lead to incremental benefit from an investor protection perspective.