ASSOCIATION FRANÇAISE DES MARCHÉS FINANCIERS

FINANCIAL MARKET PROFESSIONALS

AMAFI / 19-110
26 November 2019

REVISION OF MiFID 2
Investor protection
-
"Product Governance" Annex

AMAFI Proposals

PRIORITIZATION OF POINTS AND SUMMARY OF CHANGES PROPOSED AT LEVEL 1

(1) Reintroducing more proportionality for simple financial instruments
- See amendment of Recital 71 of the Level 1 Directive

(2) Clarify the Distributor concept to exclude "passive" / "broad" distribution
- See amendment of Recital 71 of the Level 1 Directive
- See amendment of Articles 16.3 and 24.2 of the Level 1 Directive

(3) Exclude from the Product Governance field negotiations between eligible counterparties
- See amendment of Recitals 103 and 104 of the Level 1 Directive

MiFID 2 adopts new investor protections by introducing a mandatory framework for the design and distribution of financial instruments. These new provisions, which are set out in Chapter III of the MiFID 2 DD[1] under the heading "Product Governance", are one of the major advances of MiFID 2.

Implementation of these provisions by the relevant institutions is a significant challenge due to the legal, organisational and IT consequences they entail. They raise key commercial issues because Product Governance regulates the supply and distribution of ISPs' financial instruments.

The new Product Governance requirements oblige "Manufacturers" and "Distributors" of financial instruments to prevent conflicts of interest and to control the risks of inappropriate marketing of products or the creation of products without any defined interest for clients. Accordingly, these provisions contribute to improving investor protection because their aim is to better target investors compatible with each product marketed by defining "Target Markets", more fully informing clients about the nature of the product or service offered and manufacturing only products that meet the needs and objectives of clients targeted. The Product Governance provisions defines the responsibilities of each actor in the distribution chain, from the designer to the distributor, as well as the exchanges between the two. The scope of this Product Governance system, as currently defined, is very broad, and its obligations apply to all clients, regardless of how they are classified, as well as to all financial instruments[2].

This new system undoubtedly represents an advance in investor protection. However, the work carried out over the past several years on the interpretation and implementation of the obligations it imposes has shown that, due to its ambitious nature, certain criticisms are justified and should be taken into account for purposes of the MiFID 2 revision project.

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[1] The provisions of Commission Delegated Directive (EU) 2017/593 of 7 April 2016 supplementing MiFID 2 ("MiFID 2 DD") on Product Governance have been transposed in France in Book III, Chapter III, of the AMF General Regulation.
[2] As defined by MiFID 2 (Annex I, Section C), as well as structured deposits. However, they may be applied in a proportionate manner depending on the category of clients and the nature of the financial instruments (see MiFID 2 DD 2017/593, recital 18).

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These criticisms have led to the revision proposals discussed below, which focus on the two general messages put forward in the introduction:

***(1)* Simplifying, clarifying and making the system more comprehensible;** and

***(2)* Reintroducing greater proportionality and more fully reflecting the specificities of the wholesale market.**

Proposals to simplify and clarify the scope of Product Governance and to more extensively apply the principle of proportionality

The Product Governance system is, firstly, very (perhaps overly) ambitious given its extremely broad scope. While this has the advantage of covering all possible situations, it quickly became apparent from the implementation work carried out that, in a number of cases, its objectives are not particularly or not at all pertinent.

(1) Negotiations solely between eligible counterparties outside distribution channels

When an eligible counterparty purchases or trades a financial instrument with another ISP for its own account without any intention of reselling it to its own clients, the counterparty does not act as a Distributor for Product Governance purposes ("Distributor"). The eligible counterparty is the ISP's only "client" for that specific transaction. If an eligible counterparty places an order for its own account with another ISP, both counterparties have similar roles vis-à-vis each other: each one is both a client and a supplier, and no other "end client" can be considered to be a target. Therefore, Product Governance requirements should not apply to negotiations conducted exclusively between eligible counterparties.

At the very least, the principle of proportionality, adapted to the wholesale market, should be taken into account to a greater degree for these situations. In accordance with current practice, eligible counterparties are already informed of the characteristics of the financial instruments in which they trade (for example, by providing a term sheet). Transactions that involve only eligible counterparties, who do not subsequently redistribute the products to end clients, do not require furnishing all information intended for less sophisticated clients. Concerning the information about products that Manufacturers must provide to Distributors, since eligible counterparties are both knowledgeable and experienced with respect to the products, and the knowledge and experience of the counterparties is equivalent, why should one counterparty be required to furnish this information to the other? Concerning the information required to monitor transactions in relation to the identified target market, which of the two counterparties should submit a report to the other? With respect to the obligation to regularly review these target markets, in the case of eligible counterparties, for what purpose?

These obligations should not apply in these cases.

(2) Issues of financing products: ordinary shares and bonds

Product Governance obligations apply to all types of clients, all investment services and all products regardless of their complexity. However, AMAFI notes that these obligations were primarily designed for structured products, which are actually "manufactured"[3] by ISPs. On the other hand, in the case of so-called "vanilla" products[4], the application of Product Governance obligations is more difficult to understand, in particular in the primary market where the added value is, in principle, very low or non-existent.

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[3] "... *ensure that the investment firms which manufacture financial instruments ensure that those products are manufactured to meet the needs of an idnetified target market of end clients* ..." (*MiFID 2, recital 71*).

[4] **"Ordinary" shares and bonds** admitted to trading on a regulated or equivalent market or MTF, which are classified as non-complex financial instruments within the meaning of Article 25(4)(a) of MiFID 2, and equity-linked products, such as bonds that are convertible and/or exchangeable into shares that are admitted to trading on a regulated or

a) An ISP that advises an issuer should not be considered the Manufacturer of a vanilla product

A Manufacturer is an ISP that manufactures financial instruments, which encompasses the *"creation, development, issuance and/or design of financial instruments"*[5]. However, in the case of issues of vanilla products, if the issuer is not subject to MiFID 2 (for example, a corporate issuer), it does not itself meet the prerequisites of the definition of Manufacturer. A commonly accepted interpretation of recital 15[6] of the MiFID 2 DD considers that the issuer's ISP adviser in connection with an issue of vanilla products is the "Manufacturer" of such products for Product Governance purposes.

However, it bears noting that the advice provided by the ISP in this context does not concern the product as such or its functioning but, rather, the characteristics of the issue (terms and conditions, timetable, etc.). Moreover, in practice, it has proved very complicated to harmonise the identification of Target Markets, for Product Governance purposes, with the types of investors targeted for a given issue in accordance with the Prospectus Regulation. In particular, a number of Product Governance provisions seem inapposite for these financial instruments, especially the obligations that apply over time, given the fungible nature of these instruments[7].

For the foregoing reasons, these ISPs should not be classified as "Manufacturers" of vanilla products because practice has shown that this provides no added value apart from a purely formal exercise to identify a Target Market that, by its nature, is very broad and identical for the same type of financial instrument[8].

b) Introduce additional proportionality in the application of Product Governance provisions to vanilla products

Even in the absence of a MiFID 2 Manufacturer, vanilla products that are both distributed on the primary market and traded on the secondary market are subject to the Product Governance provisions.

In this case as well, given the inherent nature of these products, which by their nature must be accessible to as many people as possible, the current system fails to sufficiently apply the principle of proportionality, in particular with regard to the following factors:

a) **Identification of the positive target market:** it should be possible to define a "single" target market. For example, such market could include, on the one hand, all shares and, on the other hand, all bonds with similar characteristics.

b) **Identification of the negative target market:** in light of the nature of these products, the need to identify a negative target market should be acknowledged to be rare[9] or non-existent.

c) **Costs:** by nature, vanilla products do not incur a product "manufacturing" cost. Therefore, the obligations to verify the compatibility of these costs and charges should be deemed to have been met.

d) **Regular review of the product:** given the nature of these products, AMAFI considers that it is disproportionate, unnecessary and perhaps impossible (particularly on the primary market) to conduct regular reviews.

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equivalent market or MTF, even if they are not classified as non-complex financial instruments within the meaning of the article referenced above.

[5] MiFID II DD, Article 9(1).

[6] *"Investment firms that ... advise issuers on the launch of new financial instruments should be considered as manufacturers ..."*.

[7] See AMAFI Guide No. 18-60, "MiFID 2 Product Governance", Annex 4, 7 Nov. 2018.

[8] Ibid.

[9] On this point, the example ESMA gives in its Guidelines of a negative target market for a share encompassing clients looking for full capital protection, who are fully risk averse and want a fully guaranteed income (*ESMA Guidelines (English version), Annex V, Case study 4*) is particularly regrettable and harmful and should be deleted.

e) **Scenarios:** similarly, the obligation to undertake analyses of various scenarios seems to be apposite for structured products, but not particularly pertinent for shares and bonds.

f) **Reports of sales outside the target market:** given the very broad target markets for these products, a limited number of sales outside the target market is generally to be expected. Moreover, given the limited scope of its obligations, the “Manufacturer” will not perform a regular review of the Product (or its target market) and, therefore, these reports on sales outside the target market would be pointless in any event.

(3) “Broad distribution” in the absence of a link with the Manufacturer

“Broad distribution” concerns, in particular, ISPs that provide an RTO or order execution service enabling their clients to process financial instruments available on the secondary market via trading venues or OTC transactions. Should an ISP that provides such a service be considered a Distributor in all cases? In particular, if it receives an order “passively” (i.e. if receipt is not preceded by any of the following actions: a marketing campaign, providing recommendations or advice to clients on the product in question, sending promotional communications about the product to its clients, providing advice to clients, etc.) for a product to which it has no ties (it does not know the “Manufacturer” and receives no remuneration therefrom to market the Product), and the only service provided to the client is to transmit this order for execution or to execute the order, should the ISP be considered to “market” the Product and therefore that it is the Distributor of the financial instrument?

ESMA[10] answered this question affirmatively and considers that an ISP is also a Distributor if it decides on the products offered to clients acting at their own initiative, even if such ISP does not actively market these products.

Precisely because these “distributors” have only limited information, a legitimate question arises as to the benefit of considering that they are Distributors. Moreover, these arrangements are most often specific to “vanilla” products (*see Section (2) above*) such as shares or bonds. Pursuant to the principle of proportionality it should be fairly simple to identify the target markets for products that are, by their nature, suitable for “mass” retail clients. However, the question this raises is what benefit would accrue by identifying such a “target” market, which by definition would be very broad. It is also important to note that Product Governance requirements are not limited to the identification of the Target Market and that Distributors are subject to other obligations, such as regularly reviewing the products distributed and providing information on sales. In these cases as well, these provisions appear to be of limited utility, whereas they have a significant regulatory cost for these firms that provide execution services only, but no investment advisory or discretionary management services.

Lastly, the feedback from professionals shows that it is extremely complicated from a practical point of view for Distributors to have the exchanges of information required by the Product Governance system with a multitude of Manufacturers with whom they do not have an established relationship.

Requiring Distributors to identify in advance all products on which their clients could potentially place orders seems disproportionate. The number of financial instruments concerned is enormous. Moreover, commercially speaking, the Distributor cannot refuse to accept an order from a client for a product that it has not identified in advance, especially if the order is placed by telephone.

The system should therefore focus on the Distributor’s distribution policy, i.e. through what channel and with what service it provides or does not provide access to certain markets to certain of its clients because, in this context, a product-by-product approach is not pertinent. If an ISP provides only an RTO or simple execution service, its role from a Product Governance standpoint is limited solely to determining to what

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[10] *“ ... Distributors should also decide which products will be made available to (existing or prospective) clients at their own initiative through execution services without active marketing, considering that in such situations the level of client information available may be very limited.”* (*Guidelines on MiFID II product governance requirements* (*ESMA35-43-620*) issued on 2 June 2017 *“ESMA Guidelines”, § 31*).

market(s) or venue(s) it will provide access to its clients because it does not receive from the Manufacturer of each financial instrument referenced by the market or venue detailed information on the Target Market for each financial instrument, if in fact any exists. Product Governance obligations should therefore be applied proportionately to the service provided and not on a product-by-product basis, as European regulated markets should generally be considered to be accessible to all investors.

This observation is evident for firms that deal with retail clients. It applies all the more so to firms that have only professional clients.

These are the rationale for AMAFI's proposals to amend the definition of the distributor concept at both Level 1 and Level 2 in order to target entities that "market or recommend" financial instruments but not those which merely "offer" or "propose" the said financial instruments.

Simplifying and making more comprehensible reports of sales outside the Target Market

Distributors are required to provide Manufacturers with information on sales made outside the Target Market, and the Manufacturer must ensure that the product is in fact distributed to the target market[11].

An ambiguity remains about the Distributor's responsibility for this report. It would be helpful to clarify, for example in the Level 2, that the Distributor is solely responsible for this obligation. Therefore, Manufacturers that have used their best endeavours to actually obtain this information but have nevertheless not received any reports should be able to validly assume that no sales have been made outside their target market or that such sales are not sufficiently relevant to report.

Moreover, the nature of the sales to be reported is complex.

ESMA has specified the scope of the sales to be reported. As a welcome exception, sales made outside the target market for diversification or hedging purposes need not be reported[12], provided such sales are compatible with the client's total portfolio or the risk being hedged (however, this exception cannot apply to deviations from the first two criteria[13] of the target market). However, sales into the negative target market must always be reported[14] even if they are made for diversification or hedging purposes.

Ultimately, the scope of sales to be reported is based on a complex combination of statements and exceptions that should undoubtedly be simplified. In fact, under the principle of proportionality, should it not be above all the sales made into the negative target market that should be identified?

Therefore, on the basis of the same concern for proportionality, it should be made clear that the reporting requirement is not systematic and that only a certain volume of sales outside the target market triggers the obligation to report them. If a Distributor identifies a few sales outside the target market to be reported, but such sales are very small or marginal in relation to the total volume of sales made (including sales made within the target market), is it worthwhile to require the Distributor to report them anyway? Furthermore, if this departure from the target market is perfectly justified in a particular case, for example because the client has requested to invest in a product at its own initiative, is it really necessary to report it to the Manufacturer? It would seem both more consistent with the original objective of this report (i.e. to confirm the pertinence of the defined target market) and the principle of proportionality, which should be re-emphasised, to give the Distributor certain discretion to determine if it is necessary to report sales outside the target market.

[11] MiFID II DD, Article 9(14): "Investment firms shall consider if the financial instrument remains consistent with the needs, characteristics and objectives of the target market and if it is being distributed to the target market, or is reaching clients for whose needs, characteristics and objectives the financial instrument is not compatible."
[12] ESMA Guidelines, § 54.
[13] Therefore, sales made outside the positive target market because they do not meet the "Type of client" and/or "Knowledge and experience" criteria cannot be justified for diversification or hedging reasons. Accordingly, they must be reported in all cases.
[14] ESMA Guidelines, § 55.

For these reasons, AMAFI proposes to simplify the reporting of sales outside the target market by focusing on sales made into the negative target market and giving Distributors certain discretion to determine the need to report such sales to the Manufacturer.

Moreover, feedback received tends to show that Manufacturers generally receive few reports from Distributors on this subject. On average, AMAFI Manufacturers report a reporting rate of around **only 30%** from all their Distributors, a significant share of which is attributable solely to French distributors. From a qualitative point of view, the majority of Manufacturers agree that in a number of cases the information does not really enable drawing reliable conclusions as to whether or not the definition of the target market needs to be revised. Many Distributors also point to operational obstacles – chief among them, information systems and IT tools – that make the task as currently required by the laws in force extremely complex, difficult and burdensome.

Finally, and to echo the issue raised in Section *(3)* concerning scope ("broad distribution"), the complexity of this reporting is further increased if there is no contractual relationship between the Distributor and the Manufacturer.

The principle of proportionality should be re-emphasised with respect to the requirement to monitor products throughout their lives

Article 9.15 of the Delegated Directive requires Manufacturers to identify *"crucial events that would affect the potential risk or return expectations"* of the product, such as:

(a) The crossing of a threshold that will affect the return profile of the product; or
(b) The solvency of certain issuers.

Feedback obtained on the implementation of this obligation shows that it cannot be applied consistently due to the variety of situations concerned. For example, depending on the level of granularity the Manufacturer decides for the purposes of applying it, this obligation may become quite onerous even if not justified by the category of end clients targeted. Although this review is particularly beneficial if the end client is a retail investor, it seems much less useful in the case of sophisticated clients.

Furthermore, the factors chosen to identify such reviews and their frequency vary considerably depending on the type of financial instrument. By their nature, these reviews will not be carried out based on whether the product is a structured product such as an EMTN sold to retail clients or an OTC derivative traded with a professional client who frequently trades in these financial instruments. Moreover, such review will be meaningless for vanilla products[15].

Therefore, it is essential to provide legal certainty to Manufacturers by explicitly stipulating that this obligation is to be applied in a manner appropriate and proportionate to the nature of the relevant financial instrument and the category of the final client, i.e. to the nature of the Target Market identified.

[15] See, above, "Introduce additional proportionality in the application of Product Governance provisions to vanilla products".

PROPOSED AMENDMENTS TO THE LAWS

Level 1
DIRECTIVE 2014/65/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU

Recitals

(71) Member States should ensure that investment firms act in accordance with the best interests of their clients and are able to comply with their obligations under this Directive. Investment firms should accordingly understand the features of the financial instruments ~~offered~~ **marketed** or recommended and establish and review effective policies and arrangements to identify the category of clients to whom products and services are to be provided. Member States should ensure that the investment firms which manufacture financial instruments ensure that those products are manufactured to meet the needs of an identified target market of end clients within the relevant category of clients, take reasonable steps to ensure that the financial instruments are distributed to the identified target market and periodically review the identification of the target market of and the performance of the products they offer.

It should also be understood that investment firms advising issuers on the launch of new financial instruments should not be considered as manufacturer of those financial instruments.

Investment firms that **market** ~~offer~~ or recommend to clients financial instruments not manufactured by them should also have appropriate arrangements in place to obtain and understand the relevant information concerning the product approval process, including the identified target market and the characteristics of the product they **market** ~~offer~~ or recommend. That obligation should apply without prejudice to any assessment of appropriateness or suitability to be subsequently carried out by the investment firm in the provision of investment services to each client, on the basis of their personal needs, characteristics and objectives.

In order to ensure that financial instruments will be ~~offered~~ **marketed** or recommended only when in the interest of the client, investment firms ~~offering~~ **marketing** or recommending the product manufactured by firms which are not subject to the product governance requirements set out in this Directive or manufactured by third-country firms should also have appropriate arrangements to obtain sufficient information about the financial instruments.

(103) For the purposes of this Directive eligible counterparties should be considered to be acting as clients **except where this would be manifestly disproportionate regarding their level of sophistication and all the more if they wish to waive the protection provided for them according to this Directive**.

(104) The financial crisis has shown limits in the ability of non-retail clients to appreciate the risk of their investments. While it should be confirmed that conduct of business rules should be enforced in respect of those investors most in need of protection, it is appropriate to better calibrate the requirements applicable to different categories of clients. To that extent, it is appropriate to extend some information and reporting requirements to the relationship with **first professional clients and, only where relevant,** eligible counterparties. In particular, the relevant requirements should relate to the safeguarding of client financial instruments and funds as well as information and reporting requirements concerning more complex financial instruments and transactions. **On the other hand, this extension is not appropriate for the simplest financial instruments.** In order to better define the classification of municipalities and local public authorities, it is appropriate to clearly exclude them from the list of eligible counterparties and of clients who are considered to be professionals while still allowing those clients to ask for treatment as professional clients on request.

Those amendments in Level 1 recitals aim at:

- Clarify that “passive distribution” should be excluded from the scope of the product governance requirements;
- Legitimize the reliefs requested for eligible counterparties;
- Affirm the principle of proportionality in the application of the product governance requirements;
- Prevent the maintenance of Recital 15 of the Level 2 Directive, which wrongly qualifies the advising investment firm of an issuer as the Manufacturer of the issued instrument.

Article 16

Organisational requirements

[…]

3. An investment firm shall maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest as defined in Article 23 from adversely affecting the interests of its clients.

An investment firm which manufactures financial instruments for sale to clients shall maintain, operate and review a process for the approval of each financial instrument and significant adaptations of existing financial instruments before it is marketed or distributed to clients.

The product approval process shall specify an identified target market of end clients within the relevant category of clients for each financial instrument and shall ensure that all relevant risks to such identified target market are assessed and that the intended distribution strategy is consistent with the identified target market.
An investment firm shall also regularly review financial instruments it offers or markets, taking into account any event that could materially affect the potential risk to the identified target market, to assess at least whether the financial instrument remains consistent with the needs of the identified target market and whether the intended distribution strategy remains appropriate.

An investment firm which manufactures financial instruments shall make available to any distributor all appropriate information on the financial instrument and the product approval process, including the identified target market of the financial instrument.

Where an investment firm ~~offers~~ <u>**markets**</u> or recommends financial instruments which it does not manufacture, it shall have in place adequate arrangements to obtain the information referred to in the fifth subparagraph and to understand the characteristics and identified target market of each financial instrument.

The policies, processes and arrangements referred to in this paragraph shall be without prejudice to all other requirements under this Directive and Regulation (EU) No 600/2014, including those relating to disclosure, suitability or appropriateness, identification and management of conflicts of interests, and inducements.

[…]

Article 24

General principles and information to clients

[…]

2. Investment firms which manufacture financial instruments for sale to clients shall ensure that those financial instruments are designed to meet the needs of an identified target market of end clients within the relevant category of clients, the strategy for distribution of the financial instruments is compatible with the identified target market, and the investment firm takes reasonable steps to ensure that the financial instrument is distributed to the identified target market.

An investment firm shall understand the financial instruments they ~~offer~~ **market** or recommend, assess the compatibility of the financial instruments with the needs of the clients to whom it provides investment services, also taking account of the identified target market of end clients as referred to in Article 16(3), and ensure that financial instruments are ~~offered~~ **marketed** or recommended only when this is in the interest of the client.

[…]

The substitution of the word "*offer*" by "*market*" in accordance with Articles 16.3 and 24.2 of the Level 1 Directive aim at clarifying that "passive distribution" should be excluded from the scope of Product governance requirements.

Article 30
Transactions executed with eligible counterparties

1. Member States shall ensure that investment firms authorised to execute orders on behalf of clients and/or to deal on own account and/or to receive and transmit orders, may bring about or enter into transactions with eligible counterparties without being obliged to comply with the obligations under **Article 16(3), with the exception of paragraph 1**, Article 24, with the exception of paragraphs 4 and 5, Article 25, with the exception of paragraph 6, Article 27 and Article 28(1) in respect of those transactions or in respect of any ancillary service directly relating to those transactions.

Member States shall ensure that, in their relationship with eligible counterparties, investment firms act honestly, fairly and professionally and communicate in a way which is fair, clear and not misleading, taking into account the nature of the eligible counterparty and of its business.

The Product Governance provisions are set out in both Article 16(3), paragraphs 2 to 6, and Article 24(2). Article 30, which is the basis for the principle that investor protection provisions do not apply to transactions between eligible counterparties, already excludes Article 24(2). Therefore, the exclusion of Article 16(3) should be added to make fully clear that investor protection provisions do not apply to transactions between eligible counterparties.

Level 2
COMMISSION DELEGATED DIRECTIVE (EU) 2017/593 of 7 April 2016 supplementing Directive 2014/65/EU

Recitals

(15) In order to avoid and reduce from an early stage potential risks of failure to comply with investor protection rules, investment firms manufacturing and distributing financial instruments should comply with product governance requirements. For the purpose of product governance requirements, investment firms that create, develop, issue and/or design financial instruments, ~~**including when advising corporate issuers on the launch of new financial instruments**~~, should be considered as manufacturers while investment firms that ~~**offer or**~~ ~~**sell**~~ **recommend or market** financial instrument and services to clients should be considered distributors.

(18) In light of the requirements set out in Directive 2014/65/EU and in the interest of investor protection, product governance rules should apply to all products sold on primary and secondary markets, irrespective of the type of product or service provided and of the requirements applicable at point of sale. However, those rules may be applied in a proportionate manner, depending on the complexity of the product and the degree to which publicly available information can be obtained, taking into account the nature of the instrument, the investment service and the target market. Proportionality means that these rules could be relatively simple for certain simple, products distributed on an execution-only basis where such products

would be compatible with the needs and characteristics of the mass retail market. **It also means that some of these rules are not proportionate for simple products, such as shares and bonds.**

These proposals meet the need to introduce additional proportionality in the application of Product Governance provisions to vanilla products.

In Recital 15, the replacement of the terms "*offer or sell*" by *"recommend or market"* is intended to make the definition of Distributor in Article 10 of the same Directive consistent and meets the need to make clear that passive distribution should be excluded from the scope of the Product Governance provisions.

Article 10
Product governance obligations for distributors

1. Member States shall require investment firms, when deciding the range of financial instruments issued by themselves or other firms **~~and services~~** they intend to ~~offer or~~ recommend to clients, to comply, in a way that is appropriate and proportionate, with the relevant requirements laid down in paragraphs 2 to 10, taking into account the nature of the financial instrument, the investment service and the target market for the product.

Investment firms that do not decide to include any financial instrument in their range and they do not recommend that financial instrument may agree to execute a client order on that financial instrument without complying with the requirements set out in paragraphs 2 to 10.

Member States shall ensure that investment firms also comply with the requirements of Directive 2014/65/EU when **~~offering or~~** recommending financial instruments manufactured by entities that are not subject to Directive 2014/65/EU. As part of this process, such investment firms shall have in place effective arrangements to ensure that they obtain sufficient information about these financial instruments from these manufacturers.

These proposals meet the need to clarify that "broad" distribution should be excluded from the scope of the Product Governance provisions, in accordance with amendments proposed in Level 1.

Article 9
Product governance obligations for manufacturers

15. Member States shall require investment firms to review financial instruments prior to any further issue or re-launch, if they are aware of any event that could materially affect the potential risk to investors and at regular intervals to assess whether the financial instruments function as intended. Investment firms shall determine how regularly to review their financial instruments based on relevant factors, including factors linked to the complexity or the innovative nature of the investment strategies pursued. Firms shall also identify, **in a manner appropriate and proportionate to the nature of the financial instrument and the target market for the financial instrument**, crucial events that would affect the potential risk or return expectations of the financial instrument, such as:
(a) the crossing of a threshold that will affect the return profile of the financial instrument; or
(b) the solvency of certain issuers whose securities or guarantees may impact the performance of the financial instrument.

This addition makes clear that the monitoring obligation during the life of the products laid down in Article 9 should be applied in a manner appropriate and proportionate to the nature of the product and the category of targeted end clients.

Level 3

ESMA Guidelines on MiFID II product governance requirements

54. The distributor is not required to report sales outside of the positive target market to the manufacturer, **provided they are not made into the negative target market**. ~~if these sales are for diversification and hedging purposes and if these sales are still suitable given the client's total portfolio or the risk being hedged.~~

55. Sales of products into the negative target market should always be reported to the manufacturer and disclosed to the client, even if those sales are for diversification or hedging purposes. Moreover, even if for diversification purposes, sales into the negative target market should be a rare occurrence (see also paragraphs 67-74).
59. In relation to the reporting of information on sales outside the manufacturer's target market, distributors should be able to report any ~~decisions they have taken to sell outside the target market or to broaden the distribution strategy recommended by the manufacturer and information on sales made outside the target market (including~~ sales within the negative target market)~~, taking into account the exceptions as noted in paragraph 54~~.

74. Deviations from the target market (~~outside the positive or~~ within the negative) which may be relevant **in the distributor's opinion** for the product governance process of the manufacturer (especially **if they** ~~**those that**~~ are recurrent) should be reported to the manufacturer ~~taking into account the exceptions as noted in paragraph 54~~.
Manufacturers that have used their best endeavours to obtain this information from their distributors, but despite such endeavours have not received any reports in this respect, may validly assume that no sales have been made outside or that such sales are not sufficiently relevant to report.

These proposals meet the need to simplify the reporting of sales outside the target market and take into account the principle of proportionality to a greater degree.

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

75. The requirements set out in Article 16(3) MiFID II **do not** apply ~~irrespective of the nature of the client (retail, professional or~~ **to** eligible counterpart**ies**~~y~~).
[…]

The rest of its paragraphs will have to be revised to reflect the addition of Article 16(3) to the exclusions set out in Article 30 of the Level 1.