

**MiFID II Product Governance –**

**Approach to Implementation for Distributor Reporting**

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# **Introduction**

MiFID II imposes certain obligations on distributors and product manufacturers throughout the distribution chain to determine whether financial instruments are reaching the clients for whose needs, characteristics and objectives it was considered compatible. Investment firms are also required to 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.

Under MiFID II there are requirements for product distributors periodically to make available relevant information to product manufacturers. Product manufacturers can use this information to help inform their ongoing product monitoring and review process.

This Approach to Implementation (the Guide) sets out these obligations in greater detail and proposes a good practice approach for the industry. As such it is relevant for product manufacturers, end distributors and intermediary distributors such as platforms. The Guide has been developed jointly by TISA and the Personal Investment Management and Financial Advice Association (PIMFA), with significant input from members of the TISA MiFID II Upstream Reporting Working Group, including the Investment Association (IA) and Financial Inclusion Data Working Group (FIDWG) as well as members of the European Working Group (EWG).

# **Regulatory background**

## **EU Regulatory Position**

While distributors are not required to report transaction level sales to manufacturers they should provide the data that is necessary for the manufacturer to review the product and check that it remains consistent with the needs, characteristics and objectives of the target market as defined by the product manufacturer.

The ESMA Guidelines (see Appendix 1) on MiFID II Product Governance Requirements state that “manufacturers and distributors [should] review products on a regular basis to assess whether the product remains consistent with the needs, characteristics and objectives of the identified target market and whether the intended distribution strategy remains appropriate” and that this should be “appropriate and proportionate taking into account the nature of the investment product, the investment service and the target market of the product”.

In addition to this ESMA does state:

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

Sales conducted outside the positive target market because they do not comply with the “Client type” and/or “Knowledge and Experience” criteria cannot be justified on diversification or hedging grounds. They therefore have to be reported in all instances *(ESMA Guidelines, Annex, 3.3, § 42).*

*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).*

The concept of proportionality has been included in the regulations but the implication is that applying proportionality means that greater attention should be paid to highly complex products rather than mass market retail products. The industry also has a challenge about the mechanism for reporting. This guide, together with the associated Feedback Template[[1]](#footnote-1), covers the content of the report rather than the ***mechanism*** for reporting. However, the ‘Distribution Scenarios’ section of this guide sets out possible approaches to reporting.

Whilst ESMA may provide further clarification in the future, it can be concluded that, as a minimum regulatory requirement, distributors should report back on:

1. All sales into the negative target market; and
2. All sales outside the positive target market where they do not comply with client type or knowledge and experience.

However, manufacturers may also decide that additional information is required to enable them to meet their broader governance obligations.

## **UK Regulatory Position**

In January 2018, the FCA clarified to the IA that there is no regulatory obligation upon manufacturers to ask for ‘grey area’ information, i.e. sales outside the positive target market but not in the negative target market. Given the difficulties likely to be faced by distributors in identifying and capturing such grey area sales, this clarification significantly simplifies the position in the UK.

From a UK perspective therefore, it can be concluded that the minimum regulatory requirement for distributors is to report all sales into the negative target market

The FCA has transposed these ESMA Guidelines into its rulebook under PROD3, and made it applicable to all MiFID financial instruments (see PROD 3.1.2 R). Therefore, although many manufacturers are not MiFID firms, the FCA expects them to incorporate MiFID II product governance requirements into their own governance processes. This means that UK regulated manufacturers are required to comply with these reporting guidelines regardless of whether they are MiFID firms or not – and by extension this covers all of their distribution with MiFID distributors.

Manufacturers will wish to consider what information they need to help inform their product review process. If they are not able to obtain such information from distributors then this may need to be factored into their broader processes around the selection, due diligence and monitoring of distributors.

## **Regulatory Position – Other Jurisdictions**

Other jurisdictions have not yet placed the same explicit obligation on non-MiFID manufacturers to follow the ESMA guidelines on product governance. And to date it appears that there is still a wide variation in how willing these manufacturers are to request, or receive, reporting from distributors, or what the respective regulator’s expectations might be. For example, some manufacturers have said that they will be meeting their obligations purely through enhanced due diligence over distributors.

Although the FCA has clarified its position on “grey area” reporting, ESMA has confirmed[[2]](#footnote-2) that so called grey area reporting is expected, and the feedback template has been designed to permit distributors to comply with either approach.

# **Proportionality**

The appropriate application of the concept of proportionality is an important factor given:

* The wide variety of products in terms of complexity;
* The diverse and fragmented nature of distribution; and
* The presence of other controls available to manufacturers and distributors to give comfort that investors are being protected (e.g. distributor due diligence by manufacturers).

It is the responsibility of manufacturers to decide, with regard to the products they manufacture, which areas of focus pose the greatest risk to investors. The decision can be driven by the complexity of the product, the available distribution channel(s), or a combination of the two.

Ensuring an appropriate degree of protection for investors involves a trade-off between the risk inherent in a product (complexity) and the protection given to investors by different distribution strategies. This is further refined by other target market classifications.

The greater the risk inherent in the product, the more restricted distribution is likely to be:



When it comes to reporting, the greater the inherent risk, the more important that manufacturers are made aware when a product is sold outside the designated target market, whether outside the positive target market (“Neutral”) or in the negative target market (“Negative”)

A significant proportion of sales in the retail market will be in products that are considered to be “non-complex” or compatible with mass market retail investors. The risk to investor protection here could be considered lower than the sale of more complex products.

However, more complex products are typically distributed through channels with a greater level of investor protection built into the sales process. For example, through the delegation of decision making to a portfolio manager, who assesses the suitability of the mandate to the investor. In this case suitability is assessed holistically covering the investor’s overall financial situation and requirements. This should significantly mitigate any investor protection risk inherent in the product.

If a manufacturer decides that a non-complex product has a wide target market including execution only sales to retail investors (e.g. a mainstream UCITS fund) then its governance activity should centre on any evidence which might indicate that such a target market is too wide and no longer appropriate. Such evidence could be from a variety of sources:

1. Evidence that the product is not performing in line with expectations
2. Significant complaints activity in relation to the product; and/or
3. Distribution channel(s) used to sell the product significantly different to previous activity or expectations
4. Distribution channel(s) narrowed by the distributor on the basis that it does not consider the product fit for execution only distribution.

Only the last 3 of these would be based on information from distributors. And if there were significant complaints it is likely that these would be as a result of the first factor.

A proportional approach should ensure that manufacturers concentrate their product governance efforts on those areas and methods that are most likely to lead to the best outcomes for investors.

It is reasonable for a manufacturer to adopt a different approach for different products and distributors based on their perceived risk from an investor protection standpoint. For example, where a product has been designed for mass market retail distribution (e.g. most UCITS products), a manufacturer may consider a very light touch approach is appropriate.

On the other end, if the product is complex, the manufacturer may also decide that a higher level of monitoring and analysis is appropriate.

Equally, a good knowledge of its distributors may enable the manufacturer to concentrate its work on those distributors (or channels) where it feels the risk is greatest.

It should be noted that the key driver for a manufacturer is to be able to demonstrate it is meeting its MiFID II obligation in relation to ongoing target market assessment and its wider product and distributor governance obligations. The MiFID Feedback Template does not imply or intend to suggest manufacturers’ policing and judgement obligations in relation to a distributor’s client level suitability assessment and sales process.

Product governance and suitability, albeit connected, are two entirely separate processes. Product governance processes and procedures open a communication flow throughout the distribution chain and ensure that each participant is made aware and can understand which products are compatible with which markets, as well as whether a product’s theoretical target market correspond to the actual target market said product is sold to in practice.

Suitability is a client-level assessment aimed at establishing which products should be sold to the individual client on the basis of their objectives and needs. Target market information coming from manufacturer’s and distributor’s product governance assessments do help in this process by creating a “compatibility bucket” on the basis of the client’s characteristics, but once suitability comes into play it does not end there: there may be instances where, although a product is not considered compatible with a client on the basis of general indicators, it may be suitable in relation to the specific needs and objective of that specific client.

In a simple diagram, the relationship between product governance and suitability, from the point of view of client information available, looks more or less like this:

Manufacturer’s target market assessment

“Theoretical Target Market”

Distributor’s Target Market Assessment

“Actual Target Market”

Helps

Inform

Helps

Inform

Suitability

Assessment

## **Mass Market Retail Products**

The broadest category of target market is where a manufacturer decides that a product is compatible with retail investors and can be sold to them on an execution only basis. By definition this can only apply to non-complex products (all complex products require at least an appropriateness test).

Execution only distributors only assess Client Type from the target market criteria, and as such are only suited to products which have been designed for the mass market retail investor, which can be readily understood from the offering documents. Therefore, if a product can be sold execution only then by implication the manufacturer does not believe there is any requirement to assess other target market attributes such as ability to bear losses, needs and objectives.

For certain products that are still compatible with execution only sales but are not considered “mass market” as such, the manufacturer can give indications to the distributor that the product should be put “on the back shelf rather than on the front window” (e.g.. not to be subject to mass marketing campaigns by distributors, but instead advertised on professional press and made available upon request), by setting the “basic” indicator on “Neutral” and the “informed” indicator on “Yes”. However, please note that even with these additional precautions, if the product is distributed, for example, on an online execution only platform, this is unlikely to make much difference as ‘knowledge and experience information’ is not captured by Execution only distributors.

Other distribution channels for such products offer a higher level of investor protection, either through advice with a suitability assessment governing the entirety of the recommendation or through the delegation of decision making to a portfolio manager, who assesses the suitability of the mandate to the investor. In both cases suitability is assessed holistically covering the investor’s financial situation and requirements in their entirety.

As such it is highly unlikely that a situation will arise where such a product has been sold into a negative target market. Consequently, as one would not expect there to be any exceptions, it is considered that reporting by distributors back to manufacturers on activity would be of limited value.

This should be seen in the context of other controls that exist to ensure adequate investor protection:

1. A mass market fund is unlikely to be compatible for an investor with no ability to bear any capital loss – so a sale to such an investor in theory would be a sale into the negative market. However,
	1. If the product is sold execution only, there would be no way to record that the sale is within a negative target market as execution only services do not collect and store client information on their clients’ risk appetite;
	2. If the product was sold through an advised sales channel (investment advice or portfolio management), the sale within a negative target market would probably be as a result of a weakness in the distribution layer rather than a product issue – the range of investment products compatible with an investor with no ability to bear capital loss is rather limited, and this would be covered by the distributor as part of their suitability assessment.

In this instance, a manufacturer’s proportional approach would be to ensure appropriate product information is provided, both for use by distributors and that can be passed down to clients, as well as carrying out third party due diligence as appropriate.

1. A mass market product is unlikely to have a Negative target market for Limited Capital Loss but a manufacturer may treat this as Neutral given the subjectivity of this for each client. Regardless of the fact that FCA has clarified it does not expect reporting to manufacturers on “grey areas” such as this, any risk to investor protection could be considered adequately mitigated through the standard product disclosures and risk warnings contained in a KID or KIID
2. It is considered that product risk warnings and disclosures also adequately mitigate any risk to investor protection in respect of risk indicators (SRRI/SRI) and time horizon (e.g. PRIIPS KIDs have a minimum holding period disclosure).
3. Manufacturers already also need to have in place procedures to deal with any product-related complaints received from distributors or end investors. However, this is qualitative data that, being event-driven and to be provided on ad ad-hoc basis, cannot be systemised. As a result, the MiFID Feedback Template only covers feedback on Target Market and Distribution Channel, not complaints. Complaints should also be taken into account as part of their overall governance process. A high level of complaints may indicate that there is an issue with their target market classification requiring further investigation, or that changes should be made to their product literature and marketing documentation. Funds that could be classified as “mass market” are highly regulated in their own right through UCITS and AIFMD.
4. As part of a manufacturer’s product governance process it will also be monitoring other factors that may have an impact on the ongoing appropriateness of its target market classification. This will include changes in the investment landscape (e.g. liquidity constraints) and performance monitoring.
5. Distributors have equivalent product governance obligations, requiring them to assess the “actual target market” for a product, and classify said product by the same indicators used by manufacturers, taking into account the target market information provided by manufacturers as well as additional, more specific information on the distributor’s client base. This exercise is aimed at establishing how the manufacturer’s products are in practice compatible with the distributor’s client base.

On the basis of the above it could be considered reasonable for a manufacturer not to require full reporting from distributors where they have classified products as suitable for the mass market (ie for Retail investors and available on an execution only basis). Manufacturers can adequately fulfil their product governance obligations on these products through:

* understanding the distribution landscape
* analysis of existing sales reports
* a robust process for dealing with complaints
* compliance with product disclosure requirements
* proportionate due diligence of contracted distributors
* monitoring that the product continues to perform in line with expectations and any impact this may have on target market

There may be isolated situations, potentially as a result of an unusual product characteristic, where a manufacturer considers that the above controls are not adequate on their own. In such a case a manufacturer may decide to perform additional analysis and investigation, on just that product. This may include a request for additional reporting from distributors.

## **All Other Products**

Where products do not fall into the above category it is considered that the risk to investor protection from these products is per se greater. This is as a result of the greater complexity inherent in the product itself, combined with the fact that the regulations, or manufacturers, consider that there will be certain types of investor or distribution channel with which a product is not compatible.

At a simplistic level, whereas mass market retail products can be “sold to everyone”, other products may be classified by manufacturers as able to be “sold to everyone EXCEPT….”, or “ONLY sold to….”

This places a greater obligation on manufacturers to assess whether the product remains consistent with the needs, characteristics and objectives of the identified target market and whether the intended distribution strategy remains appropriate.

This is in addition to any sales into the negative target market, which should always be reported to manufacturers, even where for diversification or hedging purposes (in accordance with ESMA Guidelines)

Therefore, depending on the structure of the distribution chain, reports on non-mass market products may include:

1. Summary reporting of sales by Investor Type and Distribution Strategy – where contractual agreements between manufacturer and distributor contemplate this. This type of information is more frequent in distribution through platforms; and
2. Reporting on sales into the Negative Target Market and/or Negative Distribution Channel (as applicable).

# **Reporting Process**

In addition to the obligation to perform their own Target Market assessment distributors also have an obligation to report certain information back to manufacturers. Manufacturers have an obligation to use this information in their own governance process to ensure that the products are reaching the target markets they have been designed for and that their own target market assessment remains appropriate.

## **Objective – End Distributors**

Distributors must be able to generate the required reports and may need to provide information on products from multiple manufacturers in multiple jurisdictions. How easy this is for them will depend on each’s sales process and systems infrastructure. Systems infrastructure is key, as the report requires access to information on clients, transactions and products. This information may be maintained and stored on different systems.

There are a number of different ways in which a sale outside the target market or into a negative target market could arise:

1. Where the distributor disagrees with a manufacturer’s target market or distribution channel assessment and effectively over-rides it with their own, broader target market or distribution channel. There is no requirement to report where a distributor has decided to take a narrower view then the manufacturer. However, where this is because the distributor believes the manufacturer’s assessment is inappropriate, it should communicate the reasons for this back to the manufacturer

2. Where a distributor is happy to sell the product to a client for reasons of portfolio diversification or hedging

3. Where there is a mistake or flaw in a distributor’s sales process

4. Where a client specifically requests a product outside his/her target market

The first two could be considered as “structural” compared to the others that are more “client specific”.

## **Objective –Manufacturers**

Whatever information Manufacturers receive, they must be able to digest, aggregate, analyse and act on it, as well as retaining evidence that they have done so. Information may be received from a very large number of distributors across multiple jurisdictions, across different timeframes and reporting periods.

Even where a distributor has no exceptions to report, it may be preferable for manufacturers to receive some sort of a “nil return” to enable it to distinguish between distributors with nothing to report and distributors who may have something to report but have not reported. The template has been designed to allow this.

The template will not provide all the information required by a manufacturer to meet its target market related governance obligations, but it should enable a manufacturer to identify where it may have concerns which warrant:

* Further dialogue with a specific distributor, or
* Further investigation to assess whether its target market classification for a product is still appropriate

Reporting forms an important part of a manufacturer’s governance process alongside other constituents such as distributor due diligence, analysis of broad sales MI and ongoing relationship management.

Given the scale and complexity of a manufacturer’s distribution model it may apply an overall risk-based filter to ensure proportionality. This may include product complexity (for example, most UCITS products are designed for the mass retail market and there is therefore very limited scope for sales into a negative target market) or a risk-assessment of particular distribution channels or distributors

## **Multi-Layered Distribution Structures**

MiFID II and the ESMA Guidelines do not make reference to the complex but well-established nature of the existing distribution landscape. This is particularly true in the case of mass market retail funds where intermediary platforms play a significant role in providing retail investors with access to a broad range of retail products

There may be multiple layers of distribution between the end distributor and the manufacturer. This has significant implications for the practicalities of upstream reporting:

* There may be no legal relationship between the end distributor and manufacturer
* The manufacturer may not be aware of the presence or identity of an end distributor
* The distribution chain may be made up of both MiFID and non-MiFID firms. Although a participant may not be directly covered by MiFID, it may be required to comply through contractual arrangements
* There may be contractual blocks stopping the manufacturer contacting the end distributor directly
* Any information reported by distributors may need to pass through and be aggregated by other parties. As well as practical issues this may also give rise to data security concerns

Reporting will only be effective and efficient if these challenges are addressed

Where there is a regulatory “mismatch” between obligations a best efforts approach should be adopted. For example some distributors are not covered by MiFID but the manufacturers whose products they distribute are (e.g. Distributors in Latin America)

## **Full Reporting vs Exception-based Reporting**

Opinions are divided amongst distributors and manufacturers between the preference for full reporting or exceptions-based reporting, and reasons differ as well.

Distributors

Certain distributors may believe that it is easier to provide a manufacturer with more information as this means they can just take a data download from their systems with no additional manipulation or filtering. Other distributors believe the simplest way forward is only to report where necessary – i.e. in the UK for sales into the negative target market (with the expectation that volumes will be very low). Distributors have different capabilities in being able to identify and collate such information and differ in their willingness to share full information with manufacturers. In the UK many platforms and large distributors already share sales information with manufacturers, but this is less prevalent across Europe.

Manufacturers

Some manufacturers expect distributors to report the regulatory minimum, which are sales in to the negative target market. There are concerns with the practicalities and ability to digest and trawl through vast quantities of data that has not been filtered by distributors. However, where exceptions are considered highly unlikely (e.g. UCITs mass market products) they also need to be able to distinguish between distributors who genuinely have no exceptions, and those who are just not reporting anything at all.

There are also some manufacturers who believe it is better to receive more information rather than less as this will enable them to do more data mining, trend analysis etc. (although it could be argued that not all of this is strictly required from a pure investor protection perspective; there are potentially also commercial factors).

At this point it seems unlikely that the industry will be able to come to a clear agreement on this, particularly when actual volumes are still unknown, or how easy it is for distributors to compile exception reports.

Solution Providers

It is expected that a number of data and service providers will develop solutions that are able to process the huge quantities of data for full reporting. They may be able to provide additional value added services on the back of this data (analysis, trends etc).

The MiFID Feedback Template has been designed to allow for both full transaction and exceptions-based reporting.

## **Aggregation and Data Analysis**

Whatever feedback manufacturers, or their agents, do end up receiving from distributors, they will need to be able to analyse it and take appropriate actions. Realistically they will receive a mixture of full reporting, exception-based reporting, and no reporting.

It is critical that the format of this data should be aligned and consistent. Equally, given the widespread adoption of the EMT for downstream reporting of target market information by manufacturers, any reporting back up the chain should be consistent with the EMT fields.

# **European Feedback Template (EFT)**

The attached data template has been designed to facilitate the transmission of such target market and distribution channel sales data from distributors up to manufacturers in accordance with these obligations and key considerations.

We acknowledge that the overall position may change over time as different jurisdictions clarify their own requirements. A review process will be put in place to update the template accordingly

## **Scope**

Geographic

The template has been designed to follow the European MiFID Template (EMT) created by the European Working Group. It is therefore relevant for all MiFID firms.

It has been developed with input from product manufacturers and distributors as well as information providers, and has benefitted from feedback from European distribution businesses. It has been shared and discussed with ESMA and the UK regulator.

The European Working Group (EWG) has agreed to work with European associations to ensure that the EFT meets the needs of European distributors and product manufacturers, for distribution throughout Europe.

Minimum Regulatory Requirement

The minimum regulatory requirement under MiFID II is that distributors should report back on

1. All sales into the negative target market or negative distribution channel

2. All sales outside the positive target market where they do not comply with client type or knowledge and experience. Although the FCA has stated that it does not expect reporting on such “grey area” sales, this does not extend to all European jurisdictions, so this requirement has been retained in the template design. If the distributor’s jurisdiction does require “grey area” sales reporting – i.e. reporting of sales outside the positive target market, then these sales can be read as having taken place within the “Negative” rather than “Positive” target market, and therefore included in the item reported. As a consequence, values reported in countries that require “grey area” data are likely to be higher than those reported in countries not requiring these data.

However, manufacturers may also decide that additional qualitative information is required to enable them to meet their broader product governance obligations – for example, information on unusual trends or on product-related complaints, see above for more detailed information on this.

Product Type

The template has been designed from the primary perspective of fund distribution but is expected to be able to accommodate all relevant product types.

It does not differentiate between complex and non-complex products, although it is accepted that this may be a key differentiator and proportionality driver within a manufacturer’s product governance process.

The template is not designed to be used for sales in the secondary market where the manufacturer cannot be identified. In this case it is the distributor’s obligation to establish the target market for the relevant product on the basis of publicly available information[[3]](#footnote-3).

## **Context**

The template should be read in conjunction with this document and associated Q&A.

It has been designed to use as much commonality of data as possible to accommodate the different expected approaches to reporting. The intention is that this will allow for aggregation across multiple distributors to facilitate the consumption of this data by manufacturers and for it to be incorporated into their overall product and distributor governance processes.

As such it does NOT:

* Dictate the use of either an exceptions-based or full reporting methodology.
* Dictate a transaction level or aggregated approach.
* Set out different reporting for different product types or distribution channels.

The template has been designed to accommodate both full and exception reporting. We do not believe there is much value in aggregated full reporting, but accept that exception reporting may be at a transaction or aggregated level.

## **Template Structure**

As a result of the above, the template has adopted the following structure:

1. Identification of end distributor
2. Identification of next entity up the distribution chain. This may be an intermediary distributor / platform, or the manufacturer
3. Reporting period
4. Reporting format – Nil report, exception (aggregate or transaction level) or full transaction reporting
5. Identification of financial products
6. Data reporting

All fields are marked as mandatory, optional or conditional (on how/whether an earlier field has been completed).

“Mandatory” fields are fundamental for the relevant section of the template to work, and as such they should be filled. There may be fields that are shown as mandatory, but the necessary information may not be available to the reporter (e.g. because it has not been recorded or because they do not have access to it where part of a distribution chain). In this case the field should be completed as “not available” rather than being left blank.

“Conditional” fields are to be read as “mandatory where relevant/available”. Where the category or item is relevant to the report, and the data is available they should be filled.

“Optional” fields are “nice to have” information that can be provided if available. If provided, the information can be useful to reduce further communications between manufacturer and distributor.

If a field is not completed because, for example, it is not relevant, it is recommended to insert “0” rather than leaving it blank.

In terms of reporting items, the relevant categories for the purpose of the European Feedback Template are:

* Negative Target Market (NTM) – this is the negative target market identified by the manufacturer
* Negative Distribution Channel (NDC) – this applies where the product is sold through a distribution channel wider than that recommended by the manufacturer. The requirement to report NDC sales is contained in para 51 of the ESMA guidance. An NDC sale will often be within NTM as well, but not always.

## **Decision Tree**

The below decision tree sets out what information a distributor is required to provide either to the manufacturer or to the next intermediary up the chain.



# **Frequency of Reporting**

The preference is for quarterly reporting. This will enable manufacturers to incorporate the information into their overall product governance review process without too great a time lag. Reports should be sent within one month of the end of the relevant reporting period.

In order to allow for implementation and development times, ideally full quarterly reporting should start from 1st January 2019, with the first quarterly report being due in April 2019. If distributors are able to provide quarterly reporting earlier then they should do so.

Reporting for 2018 should be on a “best efforts” basis with a preference for reporting covering all of 2018 to be provided during January 2019.

# **Distribution Scenarios**

The distribution landscape across Europe is complex. There is not always a direct relationship between a manufacturer and an end distributor and there may be multiple layers of intermediate distributors in between. This has significant implications for the practicalities of transmitting the necessary information up the distribution chain.

A number of non-exhaustive scenarios have been set out below including possible approaches to reporting.

## **Group 1 – Single Tier**

In these scenarios a manufacturer has a direct relationship with the end distributor. The distribution agreement creates a direct legal and regulatory nexus between manufacturer and distributor. If the manufacturer is FCA regulated then it has obligations under PROD, regardless of whether the distributor is a MiFID firm or not.

Examples of this are:

* Manufacturer distributes directly to an adviser who then distributes to an end retail customer.
* Manufacturer distributes its funds via a platform to an end retail consumer. This could be a B2C platform or a B2B platform with orphan clients
* Manufacturer distributes directly to a DFM who then distributes to an end retail customer

It is expected that, the more complex the product (and therefore the greater the “risk”), the more likely that it will be distributed on this basis.

The end distributor’s sale process should capture all information necessary for them to meet their own MiFID obligations on Target Market assessment and would therefore allow them to provide complete reporting to the manufacturer, whether on a full transaction or exception basis.

However, it is possible that the necessary information is not captured in a way that facilitates automated upstream reporting. Information may be stored on different systems and the report may require some manual manipulation and completion.

|  |  |  |
| --- | --- | --- |
| **Reporting Type** | **Explanation** | **Template Completion** |
| NIL return | During the period there have been no sales into Negative Target Market (NTM) or sales into Negative distribution channel (NDC) | Complete rows 1-11 |
| Exceptions reporting  | Only report total sales volumes and sales into NTM or NDC | Complete rows 1-19, row 20 if reporting on transaction basis and rows 25-44 as applicable |
| Full transaction reporting | Report all sales including positive and negative and by distribution channel | Complete rows 1-24 and rows 25-44 as applicable |

Manufacturers will follow up directly with the end distributor as required.

## **Group 2 – Double Tier**

Typically, this is where a manufacturer distributes funds via a B2B platform. An adviser uses the platform as part of its business model to distribute to end investor. The adviser may distribute on advised, discretionary or XO basis (or a combination). This is the most common model for UK IFAs selling mass market retail products (e.g. UCITS) – *where the number of reportable exceptions is likely to be very low*.

The platform is acting as an intermediate distributor and will have a distribution agreement with the manufacturer. The adviser will operate based on standard “Terms of Business” with the platform. There will usually not be a direct relationship between the manufacturer and the end distributor.

The data required for reporting is likely to be split between the platform and the end distributor:

* The platform will have access to product-level target market data and some client-level transactional information.
* The end distributor should have the client related target market and distribution channel information but not necessarily readily available for automated reporting.

There are two ways in which the necessary information can be provided to manufacturers:

1. Platforms collect/collate necessary information from end distributors to enable aggregated onward reporting to manufacturer. This is the preferred option for manufacturers as it helps to ensure completeness and non-duplication of data
2. Platforms report overall information (as is available to them); but end distributors report exceptions directly to manufacturers (maybe through another service provider)

The template has been designed to allow platforms to combine reporting from multiple underlying distributors without further manipulation.

Where further investigation or action is required, manufacturers will either go through the platform or direct to the distributor, depending on the availability of information.

**Platform:**

|  |  |  |
| --- | --- | --- |
| **Reporting Type** | **Explanation** | **Template Completion** |
| NIL return | During the period there have been no sales into Negative Target Market (NTM) or sales into excluded distribution channel (EDC)Only applicable if platform has full availability of data regarding sales by underlying distributors or has received confirmation from all of them | Complete rows 1-11 |
| Exceptions reporting  | Only report total sales volumes and sales into NTM or EDCOnly applicable if platform has full availability of data regarding sales by underlying distributors or has collected this from all of them | Complete rows 1-19, row 20 if reporting on transaction basis and rows 25-44 as applicable  |
| Full transaction reporting | Report all sales including positive and negative and by distribution channelTarget Market classification may be incomplete or unavailable and therefore of limited value to the manufacturer | Complete rows 1-24 and rows 25-44 as applicable May also be incorporated into existing Sales MI reporting |

**End Distributor:**

|  |  |  |
| --- | --- | --- |
| **Reporting Type** | **Explanation** | **Template Completion** |
| NIL return | During the period there have been no sales into Negative Target Market (NTM) or sales into excluded distribution channel (EDC) | Complete rows 1-11If provided to platform and covering multiple manufacturers may be a simpler periodic attestation |
| Exceptions reporting  | Only report total sales volumes and sales into NTM or EDC | Complete rows 1-19, row 20 if reporting on transaction basis and rows 25-44 as applicable |
| Full transaction reporting | Report all sales including positive and negative and by distribution channelUnlikely to be applicable as platform has this data | Complete rows 1-24 and rows 25-44 as applicable |

## **Group 3 – Complex Multi-Tiered**

There are situations where there is more than one platform or intermediary between the manufacturer and the end distributor. For example:

* Where a platform uses another platform on an “institutional” basis (e.g. SEI and Cofunds Institutional)
* Where an IFA uses the services of a DFM via a platform

The presence of an additional layer compounds the challenges of a Double tier arrangement. As for this, the preference of the manufacturer is for the necessary information to be passed up each layer of the chain such that they receive a single consolidated report from the distributor with whom they have a direct relationship.

## **Template Completion**

The template accommodates a number of different approaches to reporting:

1. Nil return
2. Full transaction reporting
3. Exceptions only reporting

The template contains a number of sections – the first one contains general distributor or intermediary, the second contains instrument information, and the third contains a number of possible reportable items, that are to be completed depending on the approach used (full or exception reporting) and on the type of information to be provided (there are a number of NTM and NDC items available to allow maximum flexibility). The template is designed to capture data that is available to distributors and meaningful to manufacturers, and to provide manufacturers with good quality information on the extent and spread of sales of a certain financial instrument within the negative target market/distribution channel over the relevant period.

### **Nil Return**

For distributors choosing an exception reporting approach, where there has been no sale into the negative target market or outside the recommended distribution channels, distributors can still report this as a “nil return”. This enables the manufacturer to differentiate between distributors who have no exceptions to report and those distributors who should have reported but have chosen not to (for whatever reason). A “nil report” is essentially a very simple transmission of static data on the identity of the distributor and of the next entity up the chain, with an attestation (equivalent to a tick box whether the template is completed manually or through an interface) that there is nothing to report. Nil reports are completed by filling in fields 1-11, where 1-10 are static data and 11 is the attestation field.

### **Full Transaction Reporting**

Distributors choosing to engage in full transaction reporting have available a wide range of choices to categorise their transactions, whether these are within the positive or the negative target market/distribution channel.

A firm engaging in full transaction reporting should complete fields 1-10 (static data), choose the applicable option in field 11 and then select option 3 of field 12.

The firm can then insert product data in fields 13-17, and move to fields 18-44 which contain various information items that allow the firm to classify the transaction depending on whether it is within NTN/NDC or not.

If the transaction is not within NTM/NDC, then fields 25-44 are not relevant.

### **Exceptions Reporting**

Exception reporting is designed for those distributors who choose to report only on sales into the negative target market or excluded distribution channel. If there has not been any sale within the negative target market the distributors should complete on a “nil return” basis (see above).

Exceptions may be reported on an individual or aggregated basis. In both situations the reporting should be product by product (ISIN). For example, if a specific product has been sold into a negative target market on 10 occasions during the period, this can either be reported as a single exception covering 10 transactions or as 10 separate exceptions

Firms choosing to report on an exceptions basis should choose either 1 or 2 of field 12 - Reporting Format. Fields 18 to 20 and 25 to 44 should then be completed for each exception as relevant. Where the field is not relevant, there is no need to complete it.

Fields 18 and 19 are relevant to all firms reporting exceptions.

Field 20 is relevant to firms reporting exceptions at transaction level.

Fields 25-44 are relevant as applicable.

**How to complete**

Where at least one sale within the negative target market/distribution channel occurred within the relevant period, the distributor should select the option “At least one sale into a Negative Target Market (NTM) and/or to a Negative Distribution Channel (NDC)” in field 10, and then proceed to choose the approach and fill in the relevant product identification information.

In terms of reportable items, field 19 requires total aggregate value sold within the relevant period. The purpose of gathering this general information is to give the manufacturer the tools to form an idea of the scale and proportion of negative target market sales compared to the total sales of the product. This item is optional for distributors engaging in full reporting.

The dedicated NMT/NDC fields (25-44) are to be completed as relevant – that is, where one or more negative target market sales have happened in the relevant field within the relevant period. The information to be included for each category is:

* Value of NTM/NDC sales
* Number of transactions executed within the negative target market – “transactions” to be interpreted as contract notes or equivalent.

The relevant fields (here explained) are the following:

**NTM fields**

* Client type – this field identifies, for example, sales to retail customers of a non-retail instrument
* Knowledge and experience – this fields identifies, for example, sales of an instrument which has a negative target market for “basic” to a basic customer
* Ability to bear losses, risk tolerance and client needs and objectives – these fields capture negative target market sales within these categories where this is applicable – for example, in case of purchase against advice. The view of the market is that sales within these NTMs are going to be a rare occurrence. In particular, since the product risk indicators are coded differently from other NTM fields (SRI/SRRI v Y/N/Neutral), it remains to be seen how the reporting will look like.

**NDC fields**

* Distribution channels –
	+ Execution only – please note, record sales against advice here
	+ Execution only, appropriateness test failed – this specific subsection of execution only has been isolated for data quality reasons
	+ Investment advice
	+ Portfolio management

Please complete as relevant – only for the distribution channel or channels through which the negative target market sales took place. Please note that the distribution channel “investment advice” is only for standalone sales. Advisory portfolio management sales are to be considered under the channel “portfolio management”.

# **Q&A Section**

## **Distributors**

|  |  |
| --- | --- |
| **Question** | **Further Information** |
| **Why do I need to report?**If you are a MiFID firm then you have an obligation to report certain information to product manufacturers, as set out in the ESMA GuidelinesIf you are not a MiFID firm then your contractual agreement with a manufacturer may require you to report to enable the manufacturer to meet its own regulatory obligations. This may requirement may be explicit or implicit. |  |
| **When do I need to start reporting and how often do I need to report?**Distributors should already be collecting target market information. Reporting for 2018 should be sent in January 2019. Full quarterly reporting should commence in 2019 with the report for Q1 2019 being sent in April |  |
| **Who should I report to?**You should report to the next entity up the distribution chain. If you are an end distributor dealing directly with the manufacturer you should report to the manufacturer. If you are dealing through a platform, you should report to them |  |
| **Which products should I report on?**You should report on all MiFID products, where a manufacturer can be identified. |  |
| **What should I report?**You may report all transactions during a period or only on exceptions- i.e. transactions into a negative target market or distribution channel. Where you are reporting on an exceptions basis you may report each transaction or on all exceptions aggregated at product level |  |
| **What sort of transactions should I report on?**All relevant client Purchases (Sales) which have been priced by the manufacturer within the reporting period should be included i.e. the date of the Valuation Point will be used to determine inclusion. The restriction to the Purchase side only is on the basis that these are the only transactions specifically requiring an assessment of compatibility to the Target Market. Obligations in respect of Target Market Reporting are based on whether Purchases have been made outside the Target Market or into the Negative Target Market (for UK markets please see introduction). On this basis the following variants of a purchase have been deemed to be the transactions types that are in scope for reporting: 1. Lump sum purchase 2. Regular purchase 3. Switch In (the Purchase side of a switch transaction) 4. Cash Transfer In (the purchase of an asset following a cash transfer in from another provider) The following transactions should be excluded as they are not deemed to necessitate assessment as to the compatibility of the product being sold: a. Distribution Reinvestment b. Corporate Actions c. Re-registration or change of beneficial owner without consideration Where a Purchase has been placed during the reporting period and subsequently cancelled, the Purchase is not to be included, as the reporting is based on executed transactions (contract notes or equivalent).Where a Purchase has been placed during the reporting period but executed and/or settled after the end of the reporting period, the Purchase is to be included as the reference for the manufacturer is the Valuation Point. Manufacturers will need to be mindful of differences in times of execution and settlement when reconciling values. |  |
| **Can I report on multiple products in one template?** Yes - the template allows for multiple products to be reported at the same time |  |
| **Do I need to report if I have not made any sales into the negative target market?**It is important that manufacturers are able to distinguish between distributors who have nothing to report and distributors who should be reporting, but are not. The template allows for “nil returns” and this should be completed and sent to the manufacturer if you have a direct relationship. Where you are dealing through an intermediary you may send a nil return. Alternatively the intermediary may have its own process for confirming nil returns |  |
| **Do I need to report if I only ever make sales on a portfolio basis?**Yes – ESMA Guideline p55 states “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” |  |
| **What happens once I have sent the report?**Once the manufacturer has received and assessed the information they may decide that no further action is required. However they may also require that further investigation is merited. If they have a direct relationship with you they may contact you for further information. If the relationship is through an intermediary or platform they will go through them. Depending on the specifics of each set of contractual agreement, you may be contacted by the manufacturer or by the platform with such a request |  |
| **This template does not allow me to report to manufacturers on other “qualitative” aspects of MiFID II (e.g. complaints and results of my own review of target market). How should I report these back to the manufacturer?**There is already likely to be an established process for handling relevant complaints about a product. Some manufacturers and platforms may also have an annual review or attestation process that includes this. If none of these cover a situation which you believe should be reported back to the manufacturer then you should communicate this by email through the next entity in the distribution chain |  |
| **Does the template apply to MiFID instruments traded on secondary markets?**The template does not apply to instruments traded on secondary markets where you cannot identify a manufacturer. In this case the responsibility to set the target market, on the basis of publicly available information, rests with the distributor.In case of instruments traded on secondary markets where a manufacturer is identifiable, the exact nature and extent of reporting obligations is still unclear, and at this stage it may depend on the relationship and contractual agreements between the parties involved in the distribution chain. |  |

## **Manufacturers**

|  |  |
| --- | --- |
| **Question** | **Further Information** |
| **Do I need to ask distributors for information or should they provide it automatically?**The obligation is two-way: manufacturers have the obligation to review their product, and to do so they will need to ask or obtain from distributors relevant information, and distributors have the obligation to provide this information. The setup can be described as a mandatory communication channel. It is up to the parties to agree the way information is conveyed – whether this is provided in response to a periodic request from the manufacturer (“pull” model) or automatically provided by the distributor at regular intervals (“push” model). What matters is that the two-way obligation is complied with, ie, that the manufacturer obtains the information needed to review the product and that the distributor provides it.There may also be obligations from distribution agreements. It would be sensible for manufacturers to confirm their expectations with those distributors and platforms with whom they have a direct relationship |  |
| **How often should I be collecting this information?**The rules are not prescriptive of a specific period, as long as reporting takes place “regularly”. This Guide proposes that distributors should report to manufacturers on a quarterly basis. The basis of this proposition is that quarterly reporting appears to be better suited to be implemented into regular business cycles, hereby causing as little disruption as possible to business processes. |  |
| **Do I need information on all product types?**Some reporting is required on all MiFID products; however the rules also allow for an element of proportionality in this area. Manufacturers should decide what reporting they require to meet their own product governance obligations – this may be different according to product complexity |  |
| **What about products sold on the secondary market?**This is an area where we expect further regulatory clarification to be requested. Manufacturers should apply the concept of proportionality taking into account investor risk and product accessibility |  |
| **Do I need information from all distributors including those who are not MiFID firms (or outside the scope of MiFID)?**In theory distributors outside of the scope of MiFID II have no reporting obligations. However, as a manufacturer of products which are within the scope of MiFID II it could be interpreted that you should adopt a best efforts approach to obtain a reasonable level of information where this is relevant to your own product governance obligations |  |
| **How should I deal with intermediary platforms and/or end distributors with whom I have no direct relationship?**This Guide recommends that reporting and any follow-up activity should follow the distribution chain. Reporting should flow from end distributor to the next entity up the distribution chain. If you have any follow-up questions these should be directed in the first instance to the platform or intermediary with which you have a direct relationship; they should then pass this down the chain to the end distributor |  |
| **What other information should I be asking for from distributors?**This will be determined by the procedures you have in place to meet your product and distributor governance obligations. This may include information on complaints or instances where a distributor disagrees with your target market assessment |  |
| **What if I have not received any information from a distributor?**You should follow up with them to establish the reason for this. If they have not provided any information because they have nothing to report, then you may wish to ask them to provide a Nil return in the future (if they still have nothing to report). If they have failed to report for any other reason then you should agree with them how best to proceed to ensure that you are both able to meet whatever obligations you have |  |

## **Platforms**

|  |  |
| --- | --- |
| **Question** | **Further Information** |
| **What are my reporting obligations if I am not a MiFID Firm?**This will depend on the contractual agreement you have with the manufacturer. This is likely to include an obligation on you not to do anything that would prevent them meeting their own regulatory obligations. MiFID also requires intermediaries to “enable” the provision of information by distributors to manufacturers  |  |
| **Do I report on behalf of each sub-distributor or aggregate these?**This is likely to depend on your operating model. The more granular level of information you are able to provide to a manufacturer, including the identity of sub-distributors, the easier it will be for a manufacturer to gain the necessary information |  |
| **What if I do not have all of the information available to be able to report?**Ideally you should take steps to obtain this information from underlying distributors and pass it on to the manufacturer. If for any reason you are unable to collect this information from underlying distributors then you should discuss with the manufacturer and agree how they can best obtain this information. Partial information may still be of value to a manufacturer, for example information on distribution channel and client type. |  |
| **If a manufacturer contacts me for further information can I just provide them with contact details for the underlying distributor?**This will depend on the contractual agreement you have with the manufacturer and the underlying distributor |  |

# **Appendix 1 - Extracts from ESMA Guidelines**

11. These guidelines should, in accordance with subparagraph 2 of Article 9(1), and subparagraph 1 of Article 10(1) of the MiFID II Delegated Directive, be applied in a way that is appropriate and proportionate, taking into account the nature of the investment product, the investment service and the target market of the product.

54. The distributor is not required to report sales outside of the positive target market to the manufacturer if these sales are for diversification and hedging purposes and if these sales are still suitable given the client’s total portfolio or the risk being hedged.

55. Sales of products into the negative target market should always be reported to the manufacturer and disclosed to the client, even if those sales are for diversification or hedging purposes. Moreover, even if for diversification purposes, sales into the negative target market should be a rare occurrence (see also paragraphs 67-74).

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

50. In particular, while taking into due consideration the suggested distribution strategy of the manufacturer, the distributor could decide to follow a more prudent approach by providing investment services that afford a higher level of protection to investors, such as investment advice. For instance, if the manufacturer considers that the features of a given product are compatible with a distribution strategy through non-advised services, the distributor may still decide that the characteristics of its existing or prospective clients (for example, very limited knowledge and no experience with investments in that type of product, unstable financial situation and very short-term objectives) are such that investment advice would be the most appropriate choice to ensure their best interests.

51. On the contrary, the distributor could decide, in certain circumstances, to take a less prudent approach in relation to the distribution strategy defined by the manufacturer. For example, if the manufacturer deems that a given product, due to its specific features, should be offered through investment advice, the distributor could still make that product available through execution services to a specific segment of clients. In these situations, ESMA expects that the distributor would do so only after a thorough analysis of the features of the products and the target clients. Moreover, this decision should be reported to the manufacturer as part of the distributor’s obligation to provide the manufacturer with sales information in a way that the manufacturer can take it into account in their product governance process and when selecting suitable distributors (as described in paragraphs 21-22).

56. Article 16(3) MiFID II and Articles 9 and 10 of the MiFID II Delegated Directive require manufacturers and distributors to review products on a regular basis to assess whether the product remains consistent with the needs, characteristics and objectives of the identified target market and whether the intended distribution strategy remains appropriate.

57. Manufacturers should consider, on a proportionate basis, what information they need in order to complete their review and how to gather that information. In line with Recital 20 of the MiFID II Delegated Directive, relevant information could include, for example, information on which distribution channels have been employed, the proportion of sales made outside the target market, summary information of the types of client, a summary of any complaints received and questions suggested by the manufacturer to a sample of clients for feedback. Such information may be in an aggregated form and does not need to be on an instrument-by-instrument or sales-by-sales basis.

58. To support reviews by MiFID manufacturers, distributors must provide them with information on sales and, where appropriate, any other relevant information that may be the outcome of the distributor’s own periodic review. Furthermore, distributors should consider data and information that may give an indication that they have wrongly identified the target market for a specific product or service or that the product or service no longer meets the circumstances of the identified target market, such as where the product becomes illiquid or very volatile due to market changes. Any such information is subject to the proportionality principle and may generally be in an aggregated form and does not generally need to be on an instrument-by-instrument or sale-by-sale basis. However, instrument-specific information should be provided in cases with particular relevance for certain individual instruments (e.g. if the distributor comes to the conclusion that a target market for a specific product was wrongly determined).

59. In relation to the reporting of information on sales outside the manufacturer’s target market, distributors should be able to report any decisions they have taken to sell outside the target market or to broaden the distribution strategy recommended by the manufacturer and information on sales made outside the target market (including sales within the negative target market), taking into account the exceptions as noted in paragraph 54.

74. Deviations from the target market (outside the positive or within the negative)that may be relevant for the product governance process of the manufacturer (especially those that are recurrent) should be reported to the manufacturer taking into account the exceptions as noted in paragraph 54.

1. MiFID II Feedback Template. See Section 11. [↑](#footnote-ref-1)
2. Meeting with ESMA on 19th July, 2018 to discuss this guide and associated Feedback Template. [↑](#footnote-ref-2)
3. Publicly available information should be construed in the context of recital 18 and the third sub-paragraph of Article 10(2) of the MiFID II Delegated Directive (2017/593). Paragraph 61 of the ESMA Guidelines states: "*Publicly available information may only be accepted if it is clear, reliable and produced to meet regulatory requirements. For example, information disclosed in compliance with requirements in the Prospectus Directive, the Transparency Directive, the UCITS Directive, the AIFMD Directive or third-country equivalent requirements are acceptable.* [↑](#footnote-ref-3)