

October 2021

# SPOT INSPECTIONS

Summary of SPOT inspections on governance of  
financial instruments

## INTRODUCTION

As announced in the 2020 supervision priorities of the Autorité des Marchés Financiers<sup>1</sup> (hereinafter "the AMF"), a series of short thematic "SPOT"<sup>2</sup> inspections relating to governance of financial instruments were carried out during the period from October 2020 to February 2021. These inspections took place in line with the provisions of Directive 2014/65/EU of 15 May 2014 on markets in financial instruments ("MiFID II"),<sup>3</sup> supplemented by Commission Delegated Directive (EU) 2017/593 of 7 April 2016<sup>4</sup> and clarified by ESMA Guidelines 35-43-620.<sup>5</sup> The investigations covered the period 2018-2020 and concerned a sample group of five investment service providers (hereinafter "ISPs"), targeting credit institutions belonging to a group and authorised to provide the service of investment advice.

The main objective of this series of SPOT inspections was to ensure compliance of the activity of the ISPs, in their capacity as distributors, with the provisions relating to the governance of financial instruments. Particular attention was therefore paid to: i) *the financial instrument governance system and its integration into the system of the ISP's group*; ii) *the definition and monitoring of the target market*; iii) *the definition and monitoring of the distribution strategy* and iv) *sales outside the target market*.

The purpose of this summary is to provide an insight into the practices of ISPs regarding the governance of financial instruments within the specific framework of the provision of an investment advisory service to private retail clients, from the viewpoint of the system and procedures established by the firms. It should be emphasised that the implementation of these systems by the ISPs in their organisation is a prerequisite for execution of the suitability assessment measures concerning which a SPOT summary was published in March 2021.<sup>6</sup>

**This document is neither a position nor a recommendation. The practices identified as either "good" or "poor" highlight approaches identified during the inspections that may facilitate, or complicate, compliance with the regulations on governance of financial instruments.**

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<sup>1</sup> "A campaign of SPOT inspections will be run in 2020 involving institutions that distribute financial instruments to assess their compliance with these obligations relating to the identification of a target market and distribution strategy", excerpted from the document entitled "2021 supervision priorities of the Autorité des Marchés Financiers", January 2020.

<sup>2</sup> Supervision des Pratiques Opérationnelle et Thématique (operational and thematic supervision of practices).

<sup>3</sup> Transposed into national law by Order No. 2017-1107 dated 22 June 2017 and coming into force on 3 January 2018.

<sup>4</sup> Transposed into national law by the "Arrêté" (official decision) of 3 July 2017 approving amendments to the General Regulation of the Autorité des Marchés Financiers, which came into force on 3 January 2018.

<sup>5</sup> Adopted by the AMF in its AMF Position DOC-2018-04.

<sup>6</sup> "Summary of SPOT inspections on compliance with MiFID II suitability provisions", March 2021.

## 1. SUMMARY OF THE MAIN FINDINGS OF THE INSPECTIONS

MiFID II enhanced investor protection by introducing obligations for ISPs regarding the governance of financial instruments. These measures are implemented mainly before the phase of marketing of a financial instrument to a private client. As a reminder, the due diligence specific to the investment services involved, whether RTO or investment advice in particular, may not substitute for the obligations relating to the governance of financial instruments. These obligations aim to regulate the marketing of financial instruments by requiring in particular of distributor ISPs that they identify the characteristics of the target clients and the conditions accompanying distribution of the instruments, before any individual analysis of a client's particular situation. Regarding this, the regulations provide for a sharing of responsibilities between distributors and manufacturers, which should translate into a clear and distinct breakdown of tasks relating to the financial instrument governance system.

Generally, the findings of the SPOT inspection revealed more or less sophisticated systems depending on the ISPs inspected. The organisation of committees and the procedural framework of the related processes show a good awareness and relative integration of the regulatory requirements in the financial instrument marketing processes of the ISPs of the sample group. It was found that these ISPs' membership of groups and their status of subsidiary or affiliated firm (hereinafter "affiliate") imply a coordinated and centralised awareness of their obligations at the level of the parent company, which in this framework plays a key role for the system as a whole. While the conditions of such governance appear consistent with the supervision and control obligations incumbent on the groups, the level of involvement of the ISPs of the sample group in this governance nevertheless appears insufficient and reflects a passive approach. As a reminder, the controlled firms remain separate legal entities having their own authorisations to provide the investment service involved, and they act as distributors. When the due diligence relating to the financial instrument governance system is carried out exclusively by the group's parent company, any shortcomings accordingly have repercussions on all the end distributor ISPs of that group. Moreover, the lack of effective involvement of the subsidiary/affiliate managers in the processes relating to the financial instrument governance system, especially when it is deficient, entails *de facto* a failure to comply with the ISP's obligations concerning the exercise of effective control of said system.

First, the inspection task force investigated the system governing the performance of due diligence relating to the governance of financial instruments. On the one hand, the committee organisation established shows a good awareness and structured distribution of the chain of responsibilities of the business units involved in the financial instrument governance system. In this regard, the committees' prerogatives are clear and properly documented. However, the lack of participation of representatives of the "solo" entities<sup>7</sup> in the group committees could weaken ownership of the system by the subsidiaries/affiliates and thus the effectiveness of the system, which in this sense constitutes a poor practice. On the other hand, although the procedural framework appears to be correctly defined and lists the key aspects of the financial instrument governance system, the procedures for performing the relevant due diligence may be of a very general nature and lack operational significance, especially in the case of due diligence incumbent on solo entities as mentioned above. Moreover, while all the ISPs of the sample group state that in practice they apply the group procedures, only one of the inspected firms validates them each year and formally attests that it complies with these procedures, which constitutes a good practice. Likewise, the procedures for review of the system showed an insufficient involvement of four ISPs of the sample group in the due diligence performed by their parent company, which means it is not possible to comply with the requirements stipulated by the regulations. On the other hand, one ISP provides for the establishment of an annual report at the solo level, mentioning any anomalies and

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<sup>7</sup> i.e. the group's subsidiaries/affiliates

associated remediation plans, which constitutes a good practice. Lastly, concerning exchanges of information between the distributor and manufacturer ISPs, the task force was able to observe a lack of formalism, or even a lack of a framework in the procedures, making it impossible to ensure compliance with the requirements laid down by the regulations. On the other hand, the task force observed the establishment of agreements making it possible to define contractually the conditions of exchanges with the manufacturers within the framework of the governance system, which constitutes a good practice.

Second, it was noted that the definition of the target market for the group financial instruments distributed by the inspected firms was once again incumbent almost exclusively on the parent company. The firms adopt the target market proposed by the group or the manufacturer as is, without studying any specific features of their clients, which is inadequate to meet the regulatory requirements. The same goes for the review of the target market which is performed by the group for four out of five firms. On the other hand, the characterisation adopted by the five ISPs of the sample group effectively adopts the five categories set by the ESMA guidelines: *i) the type of client targeted by the product (distinguishing between "retail clients", "professional clients" and "eligible counterparties"); ii) knowledge and experience; iii) financial situation and in particular the ability to bear losses; iv) risk tolerance and the compatibility of the product's risk/reward profile with the target market; and v) clients' objectives and needs.* In practice, the results of the tests performed on the samples showed an imperfect implementation of the established system. In particular, only one firm had defined a target market for each financial instrument, with the other ISPs of the sample group being at definition levels ranging from 80% to 90%, which is insufficient to comply with the regulations. Moreover, the task force noted for three of the firms inspected that the risk rating (SRI/SRRI) of certain financial instruments was not adopted in the formal definition of the target market, which constitutes a poor practice. Furthermore, two firms did not always use the latest version of the KID or KIID in the matrix chart for formal definition of the target market, which means it is not possible to comply with the regulations. The inspection task force noted primarily as a poor practice common to the five firms inspected the fact that they make no distinction between the client's knowledge and experience. Lastly, one of the firms of the sample group does not take clients' complaints into consideration in monitoring the target market, and three others have no alert procedure, criterion or threshold making it possible to estimate systematically whether a remediation plan or other action is needed, which also constitute poor practices.

Third, the inspection task force analysed the distribution strategy of the ISPs of the sample group, and studied the definition contained in the procedures. One good practice observed, for example, consisted of defining the distribution strategy by combining the investment service involved, the distribution channel concerned and the authorised categories of advisers. On the other hand, the task force noted that the five firms adopted the distribution strategy proposed by their parent company without examining it with a "*critical eye*", regarding both its definition and its review, which is not in compliance with the regulations. Finally, one of the firms inspected "blocks" the distribution strategies defined for each product in its marketing tools, so that an adviser can only propose a product if the strategy defined for the instrument in question enables him to do so, which can be considered a good practice.

Lastly, the inspection task force investigated sales outside the target market. It thus appears that none of the firms inspected identifies or defines<sup>8</sup> by itself the so-called "negative" target market, i.e. the groups of clients whose needs, characteristics and objectives are not compatible with the financial instrument in question. In particular, two ISPs adopt the negative target market defined by the manufacturer as is, in other words no

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<sup>8</sup> Two ISPs adopt the manufacturer's "negative" target markets and three ISPs do not identify them clearly and explicitly

suitability analysis is performed. These practices do not comply with the regulations. Conversely, one ISP sends a warning message to the clients concerned, for a transaction excluding investment advisory services, if one of the client's product governance criteria belongs to the negative target market of the financial instrument, which constitutes a good practice.

## 2. CONTEXT AND SCOPE

### 2.1. PRESENTATION OF THE SAMPLE OF ISPS INSPECTED

These SPOT inspections were carried out simultaneously at five credit institutions authorised to provide the investment advisory service referred to in Article L. 3211 (5) of the Monetary and Financial Code (hereinafter, **MFC**). Of these firms, four are affiliates of French mutual banking groups for which the main operating procedures are governed by the provisions of Articles L. 512-1 et seq. of the MFC. The fifth and final firm is a subsidiary of a French banking group.

The criteria which governed the choice of the five firms selected by the task force are as follows:

- ✓ The provision of an investment advisory service;
- ✓ A significant proportion of NBI in 2019 coming from investment service activities;
- ✓ A very large majority of clients in the retail category.<sup>9</sup>

### 2.2. TOPICS ADDRESSED AND METHODOLOGY USED

The following topics were addressed during these inspections:

- The financial instrument governance system, and in particular *i) the procedural framework, ii) committees, iii) review procedures, and iv) conditions of exchange of information with the manufacturers;*
- Definition and monitoring of the target market by the distributor, and in particular *i) characterisation of the target market according to the distributor's in-house terminology, ii) application by the distributors, and iii) relevance and validity of the criteria selected;*
- Definition and monitoring of the distribution strategy;
- Sales outside the target market, and in particular the characterisation of the "negative" target market and understanding of the "grey" area.

For each firm inspected, the inspection task force analysed in particular the procedures in force regarding the topics indicated above. Moreover, in order to investigate in greater detail and assess the operational implementation of the obligations and systems mentioned above, the inspection task force established a sample of ten financial instruments for each firm. The selected financial instruments were all marketed after 3 January 2018, whether or not they were designed before that date. The sample comprises UCITS, AIFs (including formula funds and SCPI real estate investment companies in particular), but also EMTNs. So complex instruments were included in the selection, but also instruments whose liquidity can be limited (SCPI funds).

It should also be specified that, throughout this review, a distinction will be made between so-called "group" products and "local" products:

- "Group products" designates financial instruments marketed by all the subsidiaries/affiliates of a group, including the firms covered by these SPOT inspections. In this case, the manufacturers are generally the asset management subsidiaries of the groups in question, but they may also be manufacturers outside the group with which the parent company has put in place distribution arrangements and whose products are distributed by several entities of the group.

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<sup>9</sup> Professional clients being defined in Article L.533-16 of the MFC

- "Local products" designates financial instruments for which marketing is neither supervised nor determined at the group level but at the level of the distributor ISP subsidiaries/affiliates. In this case the manufacturer with which the ISP established an agreement directly is generally outside the group.

Tests were therefore performed, taking place in two phases:

- First, the aim was to check that the information used by the distributor was the most recent information, and correctly recorded in the matrix chart<sup>10</sup> enabling it to define a target market for each of the selected financial instruments;
- Next, the task force assessed the consistency and appropriateness of each target market defined by the distributor in light of the financial information for each instrument considered.

### 2.3. APPLICABLE REGULATIONS

The inspection task force based its work in particular on:

- The Monetary and Financial Code (hereinafter "MFC"), and in particular the measures resulting from the transposition of MiFID II;
- The AMF General Regulation (hereinafter "AMF GR"), and in particular the articles resulting from the transposition of Commission Delegated Directive (EU) 2017/593 of 7 April 2016;
- AMF Position DOC-2018-04 on "*MiFID II product governance requirements*" according to which the AMF applies the ESMA Guidelines 35-43-620 of 5 February 2018 on MiFID II product governance requirements.

#### **Financial instrument governance system**

- **Article L.533-24-1 of the MFC** concerning in particular the obligation for ISPs to set up appropriate systems for obtaining useful information on financial instruments and their validation process, including the target market defined by the manufacturer, and to understand the characteristics and identify the target market defined for each financial instrument;
- **Article 313-19 of the AMF GR** concerning in particular the establishment by the distributor of a product governance system and obtaining information on the financial instrument from the manufacturer;
- **Article 313-20 of the AMF GR** concerning in particular the establishment and operational maintenance of procedures enabling the distributor to decide on the range of instruments and services that it proposes or recommends;
- **Article 313-21 of the AMF GR** relating to the regular review of the product governance system and the need to take measurements;
- **Article 313-25 of the AMF GR** concerning in particular the senior managers' effective control over the product governance system;
- **Article 313-26 of the AMF GR** concerning the obligation to provide the manufacturer with information on sales outside the target market and on the review of that market;

<sup>10</sup> Table combining the characteristics of the financial instrument and the factors characterising the client's profile (according to the ISP's methodology) to define the target market for the instrument.

- **Article 313-27 of the AMF GR** concerning responsibility for compliance with the product governance obligations which, when several distributors cooperate to distribute a financial instrument or a service, is incumbent on any distributor that has a direct relationship with a client;
- **Point 6 of ESMA Guidelines 35-43-620** which summarises the definition of the distributor;
- **Recital 15 of Delegated Directive (EU) 2017/593** specifying the distributor status of investment firms which offer or sell financial instruments and services to clients.

#### **Definition and monitoring of the target market**

- **Article L.533-24-1 of the MFC** concerning in particular the obligation for ISPs to define a target market for the financial instruments that they propose, recommend or sell, and to regularly review these instruments to ensure that the defined target market remains appropriate;
- **Article 313-18 of the AMF GR** concerning in particular the obligation for ISPs to take into account the nature of the financial instrument in question to decide on the family of financial instruments that it intends to offer or recommend to its clients and define a target market for each financial instrument;
- **Article 313-19 of the AMF GR** concerning in particular obtaining information, and the use of information relating to the financial instrument obtained from the manufacturer to define the financial instrument's target market;
- **Article 313-22 of the AMF GR** relating to the review of the financial instruments proposed by the distributor to ensure that the target market and the distribution strategy remain appropriate, and updating of the product governance system if necessary;
- **Point 34 of ESMA Guidelines 35-43-620** indicating that distributors should use the same categories as the manufacturers, as listed in **point 18** of said guidelines, to define their target market, while taking into account the type of clients to whom they provide investment services, the nature of the investment products and the type of investment services that they provide;
- **Point 36 of ESMA Guidelines 35-43-620** concerning the need for the distributor to take into consideration its own clients and the information obtained from the manufacturer to define its own target market;
- **Point 37 of ESMA Guidelines 35-43-620** concerning in particular the need for the distributor to conduct a thorough analysis of its own clients to define the target market;
- **Point 38 of ESMA Guidelines 35-43-620** relating in particular to the establishment of a process by the distributor designed to refine the target market proposed by the manufacturer based on the characteristics of its own clients;
- **Point 57 of ESMA Guidelines 35-43-620** concerning in particular the need for the distributor to take into account the complaints of its clients to perform the review of its target markets;
- **Point 65 of ESMA Guidelines 35-43-620** concerning the need for the distributor to define a target market, including for financial instruments conceived before 3 January 2018, whenever those instruments are distributed to clients after that date;
- **And more generally points 35, 39 and 40 of ESMA Guidelines 35-43-620** relating to definition of the target market by distributors.

#### **Definition and monitoring of the distribution strategy**

- **Article L.533-24-1 of the MFC** concerning in particular the obligation for ISPs to regularly review the defined distribution strategies to ensure that they remain appropriate;



- **Article 313-22 of the AMF GR** relating to the review of the financial instruments proposed by the distributor to ensure that the target market and the distribution strategy remain appropriate, and updating of the product governance system if necessary;
- **Point 49 of ESMA Guidelines 35-43-620** concerning the need for the distributor to take into account the distribution strategy proposed by the manufacturer but to examine it critically in light of the information concerning its client base and the type of services provided;
- **Point 50 of ESMA Guidelines 35-43-620** relating to cases where the distributor decides to adopt a more prudent distribution strategy than that suggested by the manufacturer;
- **Point 51 of ESMA Guidelines 35-43-620** relating to cases where the distributor decides, in certain circumstances, to adopt a less prudent distribution strategy than that suggested by the manufacturer.

#### **Sales outside the target market**

- **Article 313-19 of the AMF GR** concerning in particular the identification of clients whose needs and characteristics are not compatible with the financial instrument;
- **Point 55 of ESMA Guidelines 35-43-620** relating to sales outside the target market, which should be rare and always reported to the manufacturer, even if the reason for them is portfolio diversification or hedging;
- **Point 67 of ESMA Guidelines 35-43-620** indicating that the distributor should define concretely the negative target market (i.e. the groups of clients to whom a financial instrument should not be distributed) thanks to the information it possesses concerning its client base and the financial instrument in question;
- **Point 68 of ESMA Guidelines 35-43-620** relating to the possibility of defining the negative target market as the opposite of the positive target market;
- **And more generally, points 69 to 74 of ESMA Guidelines 35-43-620** relating to requirements regarding the negative target market and sales outside the positive target market.

### 3. OBSERVATIONS AND ANALYSES

First, it should be emphasised that the inspected ISPs' membership of groups and their subsidiary/affiliate status result in practice in management of their obligations that is coordinated and centralised at the level of the parent company, which in this framework plays a key role for the system as a whole. As a reminder, these ISPs remain separate legal entities having their own authorisations to provide the investment service involved, and in this respect they act as distributors. Point 6 of ESMA Guidelines 35-43-620 recalls that "*'distributor' means [...] a firm that offers, recommends or sells an investment product and service to a client*". This clarification is based on Recital 15<sup>11</sup> and Article 313-27 of the AMF GR resulting from the transposition of Article 10 of Delegated Directive (EU) 2017/593) which provides that "*where different distributors work together in the distribution of a financial instrument or service, any distributor with a direct client relationship has ultimate responsibility to meet the product governance obligations [...]*". Accordingly, a very strong integration of firms with their parent Group cannot justify the fact that the latter is the sole player in the system and the procedures relating to the governance of financial instruments sold as part of an investment service provided by said firms. It is expected of the firms, despite their status as subsidiaries/affiliates, that they will take ownership of the financial instrument governance system. Such involvement guarantees that the firms analyse the financial instrument governance system backed by their parent company and are able to adapt it to their own situation. When the system defined by the parent company is adopted as is by the subsidiaries/affiliates, any shortcomings that it contains are *de facto* adopted by the subsidiaries/affiliates, accordingly multiplying the number of shortcomings.

The findings which are set out in the remainder of this summary call for a strengthening and an improvement of the operational scope of the systems in place on the following topics: *i) Involvement of the firms and their senior managers in the financial instrument governance system; ii) Effectiveness of the system review process; iii) Consideration of clients' specific features for defining the actual target market; iv) Procedures for review of financial instruments in relation to the defined target market; v) Integration and updating of information on financial instruments in relation to the available documentation (KID/KIID/Prospectus) and vi) Clear, explicit identification of groups of clients whose needs, characteristics and objectives are not compatible with the financial instrument in question (the "negative" target market).*

#### 3.1. FINANCIAL INSTRUMENT GOVERNANCE SYSTEM

Article L. 533-24-1 of the MFC based on the transposition of MiFID II lays down the obligation for ISPs to define a target market for each financial instrument that they propose, recommend or sell, and to regularly review those financial instruments in order to ensure that the target market and the distribution strategy defined remain appropriate.

Articles 313-19 and 313-20 of the AMF GR supplement these provisions by indicating in particular that the distributor shall *i) put in place a product governance system, ii) define a target market and a distribution strategy for each financial instrument that it distributes, and iii) ensure their regular review thanks to the establishment and operational maintenance of procedures.*

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<sup>11</sup> "*In order to prevent or reduce from the outset the risks of non-compliance with the investor protection rules, investment firms which produce and distribute financial instruments should meet product governance requirements. For the purpose of these requirements, investment firms which create, develop, issue and/or design financial instruments, including when they advise issuer firms regarding the launch of new financial instruments, should be considered as manufacturers, whereas investment firms which offer or sell financial instruments and services to clients should be considered as distributors.*"

Moreover, Article 313-25 of the AMF GR specifies that the senior managers<sup>12</sup> "*have effective control over the financial instrument governance process*".

Lastly, concerning the relations between the distributor and the producer of the financial instruments, Article L. 533-24-1 of the MFC requires that, when they do not design those financial instruments, distributors should set up appropriate systems for obtaining the information mentioned<sup>13</sup> in Article L. 533-24 (3°) of the MFC and in order to understand the characteristics and identify the target market defined for each financial instrument. These provisions are supplemented by Article 313-26 of the AMF GR which requires that the distributor provide the manufacturer with information on sales and, where relevant, information on the target market reviews that it has performed so that the manufacturer may itself have useful information for its own reviews.

Generally, the inspection task force found that, for the five firms inspected, the essential components<sup>14</sup> of the financial instrument governance system of the sample group were coordinated and supervised by the personnel employed in the group's parent company.<sup>15</sup> While the conditions of this centralised governance appear consistent with the supervision and control obligations<sup>16</sup> incumbent on the groups, the level of involvement of the ISPs of the sample group in this governance was nevertheless found to be insufficient.

In particular, even though all the firms inspected indicate that they apply *de facto* the group procedures according to a principle of subsidiarity, four of the five firms inspected were not involved by the parent company in writing and validation of the procedures organising the various processes involved in the financial instrument governance system concerning them, which is not in compliance with the provisions of Articles 313-20, 313-23 and 313-25 of the AMF GR.

Moreover, the task force's analysis of the conditions of involvement of the ISP managers in the effective control of the financial instrument governance system pinpointed certain weaknesses mainly due to a sharing of responsibilities entailing a significant imbalance between the subsidiaries/affiliates and the parent company of the parent Group. The observations of the inspection task force in this regard concern two aspects: *i) the participation and responsibilities of the managers of solo entities<sup>17</sup> in the group and individual committees*, and *ii) involvement of the managers in the definition and validation of procedures*. These aspects are discussed in parts 3.1.1 and 3.1.2 respectively of this review.

### 3.1.1. Committees

The committees put in place by ISPs to deal with matters relating to the financial instrument governance issue break down into two main categories:

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<sup>12</sup> Excerpt from Article 313-25 of the AMF GR: "*managers mentioned as applicable in 1° and 2° of Articles L. 533-25 and L. 511-51 of the Monetary and Financial Code or in Article R. 123-40 of the Commercial Code*"

<sup>13</sup> "*all useful information on financial instruments and their validation process, including the defined target market*".

<sup>14</sup> i.e. the procedures, committees, matrix charts and controls defining the target markets.

<sup>15</sup> "*A Company which controls fully, within the meaning of Article L. 233-16 of the Commercial Code, one or more other companies or which exercises a dominant influence on them due to the existence of major, enduring bonds of solidarity resulting from common financial commitments, managers or services.*" according to the terms of Article L.511-20 of the MFC.

<sup>16</sup> And in particular for mutual banking groups in accordance with the powers conferred on the headquarters under Article L. 511-31 of the MFC.

<sup>17</sup> i.e. at the individual level.

- a first type of committee dedicated to new product marketing and at the same time dealing with target markets to be defined and the distribution strategy to be adopted; and
- a second type of committee focused more on correct management of the systems in place and dealing with both the efficiency of the processes in place and review of the target markets defined according to information feedback and observed anomalies.

#### ***Committees dedicated to the definition of target markets and distribution strategies***

The organisation relating to the definition of target markets hinges on two main committees: a group product committee established by the parent companies and a local product committee, established by the distributor ISP subsidiaries/affiliates in charge of the marketing of financial instruments. The group committees have part of the prerogatives granted for the financial instrument governance issue. The committees of the distributor ISP subsidiaries/affiliates have more or less restricted prerogatives depending on the ISPs concerned. For the five firms of the sample group, the target markets for the group financial instruments (i.e. distributed by several entities in a given group) are defined by the parent company during meetings of these group committees. Within this framework, the task force observed a lack of involvement of the senior managers of the distributor ISPs in these bodies. Moreover, while four ISPs of the sample group have established distributor committees in the subsidiary/affiliate, their level of involvement and the prerogatives assigned to them remained fairly limited for three of the four ISPs concerned:

- For one ISP, the local committee allows effective examination of the target markets, distribution strategies and "negative" target markets<sup>18</sup> identified by the parent company concerning the group products. It also allows an examination of the target markets, distribution strategies and "negative" target markets of the "local" financial instruments which are not dealt with by the group committee.
- For three other ISPs, the local committee aims merely to verify the distribution channel for the financial instrument proposed in the marketing sheet communicated by the parent company, and the compatibility of the authorisations of the advisers who will have to market them. The local committee therefore has, for these three firms, no prerogatives relating to potential adjustments of the analysis conducted beforehand by the parent company concerning the content of the target markets. One of these three ISPs sells local products (i.e. financial instruments distributed only at the level of the distributor ISP subsidiary/affiliate). In this case, it is the local committee's role to define the target markets of these local financial instruments. This organisation makes it possible to comply with the regulatory obligations in this particular case.
- For a fifth ISP which distributes no local products, no local committee has been established. Hence, no analysis of the target markets, distribution strategies and negative target markets defined by the parent company during its group committee meeting is conducted by the firm.

#### ***Committees dedicated to the financial instrument governance system and the review of financial instruments***

For four ISPs of the sample group, the committees dedicated to the financial instrument governance system and review of the group financial instruments have been established by the parent company. Depending on the situation, the ISPs do not take part in them, or attend them while having limited prerogatives. More specifically:

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<sup>18</sup> As defined in paragraph 3 of Article 313-19 of the AMF GR

- One ISP selling only group products is represented by its Investment Services Compliance Manager (ISCM) in the group committee dedicated to review of the financial instrument governance system. However, in this group committee, the latter has no specific power enabling him to challenge decisions where necessary.
- One ISP selling both group products and local products reports on its observations concerning the financial instrument governance system at an internal control committee meeting, i.e. at the local level and not at the level of the parent company.
- Three ISPs do not attend the group committee meeting in charge of reviewing the financial instruments and the product governance system, which constitutes a poor practice. On the other hand, one of these three ISPs also distributes local products and has set up a committee dedicated to the review of its financial instruments at the local level.

### 3.1.2. Procedural framework

The task force analysed the procedures governing the financial instrument governance system, for each of the firms. Some provide for a regular revision of the financial instrument governance system as stipulated in Article 313-21 of the AMF GR. However, for the five firms inspected, the procedures governing the financial instrument governance system are not deployed at the local level (for products for which distribution is planned at the group level), i.e. they provide for no specific intervention of the ISPs in their operational implementation.

More specifically, it can be seen that:

- For four firms, these procedures are of a general scope and do replicate the specific features of the ISPs at the solo level, both according to their clients and with regard to their organisational model in terms of distribution network. Moreover, they undergo no validation by the managers referred to in Article 313-25 of the AMF GR in order to be formally adopted.
- One firm asserts that it complies annually with the procedures laid down by the group. More precisely, the compliance officer of the ISP validates the procedures communicated by the parent company and deploys them at the solo level by placing online procedures specific to the ISP. The ISP certifies this deployment each year by signing an attestation issued by the ISP's ISCM. This signed attestation is then sent to the compliance department of the parent company of the group to which the ISP belongs. These procedures constitute a good practice.

### 3.1.3. Review of the system

The task force observed that a review of the financial instrument governance system was performed in accordance with procedures which vary from one firm to another:

- One ISP makes provision for an annual report on financial instrument governance. This report covers the year preceding its publication (N-1) and aims to evaluate product marketing by the firm, to meet the regulatory requirements and to exchange information with the manufacturers concerned. This report lists the products analysed and provides "macro" information concerning their marketing (number of sales, number of branch offices/advisers concerned, for example). It should make it possible to draw conclusions concerning marketing, i.e. to determine whether the target market and distribution strategy criteria are complied with, or whether they show anomalies. Where applicable, an action plan is defined. The report also aims to review information feedback to the manufacturers. This report is then presented in the firm's internal control committee and also sent to its parent company. The latter supervises this process of

review by the ISP precisely by providing it with a practical guide designed to assist it in writing said report. The establishment of such a report constitutes a good practice.

- A second firm does not review the financial instrument governance system itself. This review is performed entirely by the parent company at a dedicated annual committee meeting within which the firm is represented by its ISCM.
- Three firms stated that review of the system was performed at the group level, although they provided no information enabling the task force to check the existence of such a process at the group and/or solo level, thereby not complying with the provisions of Article 313-21 of the AMF GR. However, one of these firms had such a process for local products.

To sum up the points above, for four of the five firms inspected, the procedures for review of the financial instrument governance system, for which distribution is planned at the group level, are implemented exclusively at the level of the group's parent company. The four distributor ISPs in charge of the marketing of financial instruments are therefore not involved in this review except for the announcement sent to them concerning the changes made by the group. This lack of involvement in review of the financial instrument governance system by these ISPs is not in compliance with the provisions of Article 313-21 of the AMF GR.

#### **3.1.4. Relations with the manufacturers**

Regarding exchanges of information between the distributor and manufacturer ISPs, the task force noted significant differences in the firms' involvement depending on whether it concerns products distributed at the "group"<sup>19</sup> level or at the "local" level. In particular, the task force noted that for certain firms, the conditions for exchange of information could lack a formal structure (i.e. making it impossible to ensure traceability) or even not be governed by their procedures.

More specifically:

- For one of the firms inspected, for "group" products, the conditions of exchange of information are suitably formalised by agreements stipulating that the manufacturer should provide the ISP with the necessary information for defining and monitoring the distributor's target market (including the negative target market). For local products, the group procedures stipulate that the firm must make sure to obtain the aforementioned information through an agreement with the manufacturer. The task force noted that the firm had indeed suitably established such agreements with the manufacturers of the financial instruments that it distributes locally. The establishment of these agreements constitutes a good practice.
- For another firm distributing group products and local products, exchanges of information are formalised concerning group products, but the meeting of the committee in charge of these exchanges takes place only at the level of the parent company, without the inspected firm attending. For local products, on the other hand, the firm is in direct contact with the asset management company concerned, but these exchanges are of a very informal nature and are mentioned in no procedure, and therefore do not comply with the requirements of Articles 313-18 and 313-19 of the AMF GR.
- For a third firm distributing only "group" products, contractual arrangements also exist for exchanges of information with the manufacturers, but these exchanges are conducted exclusively at the level of the parent company, which centralises all the information for its subsidiaries/affiliates.

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<sup>19</sup> Whether the manufacturer form part of the group or not

- For the latter two firms, distributing only "group" products, exchanges take place once a year at a dedicated committee meeting, but this meeting takes place at the level of the parent company, without the firms taking part.

**Regulatory reminders:**

- The distributor shall have in place adequate financial instrument governance arrangements (313-19 of the AMF GR) and shall ensure that senior managers have effective control over the process (313-25 of the AMF GR).
- The distributor shall periodically review and update its financial instrument governance arrangements, and take appropriate actions where necessary (313-21 of the AMF GR).

**Good practices:**

- Formally adopting<sup>20</sup> the group procedures when the solo entity was not involved in their production.
- Formalising (e.g. in an agreement) the conditions of exchange of information between the distributor and the manufacturer.
- Drawing up an annual report mentioning the due diligence relating to the entity's governance system.

**Poor practice:**

- Not formally adopting the group procedures while at the same time not taking part in the group committees relating to the financial instrument governance issue.

## 3.2. DEFINITION AND MONITORING OF THE TARGET MARKET

### 3.2.1. Definition and revision of the target market

Article L. 533-24-1 of the MFC requires in particular that distributors of financial instruments, when they do not design them, should acquire "*appropriate systems to obtain the information mentioned in Article L. 533-24 (3°) and to understand the characteristics and identify the target market defined for each financial instrument*". These provisions are supplemented by Articles 313-18 and 313-19 of the AMF GR which specify the obligations incumbent on ISPs within this framework.

In particular, the lack of a definition of a target market by the manufacturer should not prevent the distributor from fulfilling its own obligations. Moreover, in addition to the information that it shall collect from the manufacturer<sup>21</sup> or the person mentioned in Article 313-1 (II) of the AMF GR ("*necessary for an understanding and knowledge of the financial instrument that it intends to recommend or sell, to ensure that the instrument will be distributed in accordance with the needs, characteristics and objectives of the identified target market*"),<sup>22</sup> the ISP must clearly identify the situation and needs of the clients that it intends to target in order to ensure that their interests will be protected from any commercial or financial pressures. The distributor shall also take all reasonable measures to obtain from persons other than those mentioned above information that is appropriate and trustworthy to comply with the same requirements.

Point 34 of ESMA Guidelines 35-43-620 specifies that while distributors should use the same list of categories as that used by the manufacturers as a basis for defining the target market for their products, they should

<sup>20</sup> Without prejudice to the fact that each ISP should have a "critical look" in light of the specific features of its own clients

<sup>21</sup> Measure applicable to manufacturers subject to MiFID II

<sup>22</sup> Article 313-19 of the AMF GR

nevertheless define the target market on a more concrete level and should take into account the type of clients to whom they provide investment services, the nature of the investment products and the type of investment services that they provide.

Point 36 of said Guidelines specifies that based on the "potential" target market<sup>23</sup> defined by the manufacturer, the distributor, for its part, shall identify the "actual" target market,<sup>24</sup> taking into account the limits of the potential target market defined by the manufacturer. It is also specified that distributors should define their target market on the basis of their information and knowledge concerning their own client base and the information obtained from the manufacturer (where applicable) or the information obtained by the distributor itself by means of documentary research (especially in cases where the distributor is a new firm which does not yet have sufficient definite information concerning its own clients). Distributors should use the more general assessment of the target market performed by the manufacturer and the existing information concerning their clients or potential clients in order to define their own target market for a product, i.e. the group of clients to whom they will effectively propose the product by providing their services.

According to the provisions of Article 313-20 of the AMF GR, the distributor shall, moreover, establish and maintain operational procedures to decide on the target markets that it identifies. The target market is not fixed and the distributor is obliged to review it as mentioned in Article 313-22 of the AMF GR, particularly when it observes that the financial instrument for which the target market was defined is not or is no longer compatible with the needs, characteristics and objectives of the defined target market.

In practice, regarding the review of the target markets, one ISP does not itself review the financial instruments that it distributes and the services that it provides, thereby infringing Article L. 533-24-1 of the MFC and Article 313-22 of the AMF GR, while three other ISPs have no procedure explicitly defining the conditions of their intervention (criteria or alert thresholds) for review of the financial instruments corresponding to their defined target market, which constitutes a poor practice. Moreover, the senior managers of these three ISPs are not involved in the review arrangements, thereby infringing Article L. 533-24-1 of the MFC and Articles 313-22 and 313-25 of the AMF GR. A fifth ISP reviews at its own level the financial instruments that it distributes, both for "group" products and for its "local" products.

Moreover, one ISP does not take into account complaints by its clients when it performs the review of its target markets, which is not in compliance with point 57 of ESMA Guidelines 35-43-620<sup>25</sup> and constitutes a poor practice.

### **3.2.2. Practical conditions of characterisation of the target market**

For identifying their target markets, distributors and producers should adopt as a basis a list of five categories as defined in point 18 of ESMA Guidelines 35-43-620: *i) the type of client to whom the product is targeted (distinguishing between "retail clients", "professional clients" and "eligible counterparties"); ii) knowledge and experience; iii) financial situation and in particular the ability to bear losses; iv) risk tolerance and the compatibility of the product's risk/reward profile with the target market; and v) clients' objectives and needs.*

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<sup>23</sup> Term defined in point 21 of ESMA Guidelines 35-43-620 and used in point 35 of said Guidelines.

<sup>24</sup> Term defined in point 27 of ESMA Guidelines 35-43-620

<sup>25</sup> "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".



The group procedures of the five firms indicate effectively that they comply with this guideline and indeed mention the five categories as a scale for identifying target markets. However, it was noted that in practice the categories were sometimes incorrectly documented for certain financial instruments, as illustrated in the tables in section 3.2.4.

The operational establishment of target markets is characterised by the definition of these criteria in a matrix chart which is documented in a file (for four of the five ISPs of the sample group) or directly in the ISP's information system. Moreover, it was noted that the consistency of the criteria predefined by the manufacturer with the specific criteria of the ISP showed disparities depending on the ISP inspected. Now, it is incumbent on the distributor to translate the criteria that have been communicated to it by the manufacturer based on the five ESMA categories mentioned above, according to its in-house classification for assessment of the client's profile in light of the suitability or appropriateness rules. In addition to this "translation", the distributor must also adapt the manufacturer's target market depending on the specific features<sup>26</sup> of its clients in order to define the "actual target market", although without deviating from the fundamental decisions adopted by the manufacturer.

Regarding this, it was noted that certain ISPs did not themselves define or review the manufacturers' target markets but confined themselves to a mere translation, more or less thorough, of the criteria communicated by the manufacturers:

- For "group" products, one ISP systematically adopts the criteria of the manufacturer or the group without any analysis in identifying its target markets concerning the knowledge and experience, financial situation and in particular the ability to bear losses, and the objectives and needs of clients, thereby not complying with the provisions of Articles 313-18 and 313-19 of the AMF GR, in light of point 38 of ESMA Guidelines 35-43-620.
- Four other ISPs do not analyse the appropriateness of the target markets identified by their parent company in light of the specific features of their clients, and apply them as defined and validated by the parent company, thereby not complying with Article 313-19 of the AMF GR in light of points 34, 36 and 37 of ESMA Guidelines 35-43-620.

### **3.2.3. Verification of replication of the financial instrument's characteristics in the target market**

The inspection task force carried out tests on a sample of ten financial instruments<sup>27</sup> for each ISP in order to check that the target market was defined in a manner consistent with the available documentation and key characteristics of the financial instruments. The first part of the test carried out consisted of checking that the characteristics of the financial instruments were correctly replicated in the matrix charts for determining the target markets for each of the five firms inspected.

More specifically, the task force first checked that the distributor used the correct version of the financial instrument's KIID/KID/prospectus to determine its target market (in light of the version provided by the manufacturer). To do so, a comparison was made with the dates of the aforementioned regulatory documents.

Next, the task force checked that the matrix chart of the target market for each financial instrument of the sample replicated:

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<sup>26</sup> Which does not oblige the distributor to define a target market different from that of the manufacturer. Point 38 of ESMA Guidelines 35-43-620 stipulates that: "If, as a result of the process, the distributor comes to the conclusion that the target market of the manufacturer does not need to be refined, the distributor may use the manufacturer's target market as it is".

<sup>27</sup> These financial instruments were all marketed after 3 January 2018, whether or not they were designed before that date. The sample comprises UCITS, AIFs (including formula funds and SCPI real estate investment companies in particular), as well as EMTNs.

- ✓ The concept of complexity of the financial instrument;
- ✓ The Risk and Reward Profile (SRRI) indicated in the KID/KIID/prospectus;
- ✓ The investment horizon indicated in the KID/KIID/prospectus;
- ✓ The fund lifetime indicated in the KID/KIID/prospectus;
- ✓ Where applicable, the lock-in period indicated in the KID/KIID/prospectus;
- ✓ The capital guarantee or not at maturity of the financial instrument indicated in the KID/KIID/prospectus.

The observed rates of compliance with the aforementioned test points are summarised in anonymous form in the table below:

	Inspected investment service providers				
	ISP "A"	ISP "B"	ISP "C"	ISP "D"	ISP "E"
Up-to-date KIID/KID/prospectus	90%	100%	80%	80%	90%
Replication of the concept of complexity	70%	50%	70%	0%	90%
Replication of the SRRI	70%	60%	80%	90%	80%
Replication of the investment horizon	80%	80%	80%	100%	100%
Replication of the fund lifetime	70%	80%	50%	80%	0%
Replication of the lock-in period	80%	50%	50%	60%	0%
Replication of the capital guarantee or not	80%	80%	80%	100%	0%

#### 3.2.4. Verification of the appropriateness of the defined target market in light of the financial instrument's characteristics

The second part of the test consisted of checking that the target markets defined for each financial instrument of the sample were consistent with the financial instruments' characteristics. In particular, the task force checked that a target market had indeed been defined for each of the selected financial instruments. An analysis was also made of the consistency between the financial instrument's characteristics and: *i) the type of client targeted, ii) the knowledge and experience, iii) the financial situation and in particular the ability to bear losses, iv) the risk tolerance and v) the objectives and needs of the targeted clients.*

The observed rates of compliance with the aforementioned test points are summarised in anonymous form in the table below:

	Inspected investment service providers				
	ISP "A"	ISP "B"	ISP "C"	ISP "D"	ISP "E"
Definition of a target market	80%	80%	80%	100%	90%
Compatibility of the type of clients targeted by the product	30%	40%	20%	100%	90%
Compatibility of knowledge and experience	30%	20%	10%	0%	0%
Compatibility of the financial situation and in particular the ability to bear losses	30%	40%	30%	20%	90%
Compatibility of risk tolerance	70%	70%	70%	0%	90%
Compatibility of objectives and needs	40%	60%	50%	100%	90%

An analysis of the results of the test performed by the task force shows several findings:

- Four of the five ISPs inspected had not defined a target market for certain financial instruments of the sample. Several of the ISPs finding themselves in this case justified this situation to the inspection task force on the grounds that the target markets not defined corresponded to financial instruments marketed for the first time before the entry into force of MiFID II, on 3 January 2018. However, as a reminder, the fact of not defining a target market for a financial instrument designed before 3 January 2018, if that financial instrument was also marketed after that date, constitutes an infringement of the provisions of Article 313-18 of the AMF GR, which obliges the distributor to define the target market of each financial instrument. Point 65 of ESMA Guidelines 35-43-620 specifies, in particular, that "*products which were manufactured before 3 January 2018 but which are distributed to investors after 3 January 2018 should fall within the scope of product governance requirements applicable to distributors, and in particular the requirement to identify a target market for any financial product.*"
- Regarding the compatibility of the knowledge and experience of the group of clients targeted by the product, as illustrated in the above table, none of the five ISPs uses this category satisfactorily. For one ISP in particular, no distinction is made between levels of knowledge and experience, which results in two different criteria being added together and giving an advanced general profile when the client has a high level of experience without knowledge, which constitutes a poor practice. Moreover, two ISPs replicate the three knowledge and experience profiles indicated by the manufacturers without analysing their relevance and without any restriction on the targeted population, thereby infringing the provisions of Article 313-19 of the AMF GR, in light of point 34 of ESMA Guidelines 35-43-620. Now, by indicating systematically that its target markets consist both of clients having little experience and knowledge and experienced clients and/or "connoisseurs", without making a distinction even for complex products,<sup>28</sup> the

<sup>28</sup> Including in particular EMTNs and FIP and FCPI funds

distributor is unable to meet the requirements of Article 313-19 of the AMF GR, which indicates that the distributor must ensure that the financial instrument and the service that it intends to offer or recommend is compatible in particular with the characteristics of the identified target market. In its Guidelines 35-43-620, ESMA indicates as an example that for "*structured products with complicated return profiles, firms could specify that target investors should have knowledge of how this type of product works and the likely outcomes from the product.*"<sup>29</sup>

- Regarding the compatibility of the financial situation, and in particular the ability to bear losses of the group of clients targeted by the product, the tests performed and highlighted in the above table show that, with the exception of one ISP, the four other firms inspected show numerous shortcomings in the use of this category to define their target markets. For one ISP in particular, the "limited capital loss" criterion is alternatively set to "Yes", "No" or "Neutral" without these assessments being based on clearly defined criteria, and for instruments including no capital guarantee, even partial. For a second ISP, several financial instruments are open to all types of public despite the lack of a capital guarantee and their high SRRI.
- As regards the risk tolerance compatibility of the group of clients targeted by the product, the task force noted shortcomings at one ISP for all the target markets analysed in the course of the test. It appears that the main attitudes to risk are not clearly described, and the firm therefore deviates from ESMA Guidelines 35-43-620.<sup>30</sup> This ISP merely replicates the financial instrument's risk rating in its target market, whereas the ESMA Guidelines provide that the main attitudes to risk should be classified by category (e.g., "risk-oriented or speculative", "balanced", "cautious") and described clearly.<sup>31</sup>

#### **Regulatory reminders:**

##### *Definition of the target market*

- Establish and maintain operational procedures relating to definition of the target market (Article 313-20 of the AMF GR).
- Define target markets also for financial instruments designed before 3 January 2018 (date on which MiFID II took effect) but marketed after that date (Article 313-18 of the AMF GR in light of point 65 of ESMA Guidelines 35-43-620).
- Use reliable and appropriate information to define the target market (Article 313-19 of the AMF GR).

##### *Conditions of monitoring and review of the target market*

- Have procedures defining the conditions of review of financial instruments in relation to their identified target market (Article 313-20, 313-21 and 313-22 of the AMF GR).

#### **Poor practices:**

##### *Definition of the target market*

- Not entering the SRI/SRRI of certain financial instruments in the matrix charts for determining target markets.
- Combining the criteria of level of knowledge and experience expected of clients in defining the target market.

##### *Conditions of monitoring and review of target markets*

- Not defining the conditions of intervention (criteria or alert thresholds) making it possible to estimate whether a remediation plan or another action is necessary.

<sup>29</sup> Point 18. (b) of ESMA Guidelines 35-43-620.

<sup>30</sup> Point 34 of ESMA Guidelines 35-43-620.

<sup>31</sup> Point 18. (d) of ESMA Guidelines 35-43-620

- Not taking the complaints of clients into account in the review of target markets.

### 3.3. DEFINITION AND MONITORING OF THE DISTRIBUTION STRATEGY

#### 3.3.1. Definition and implementation of the distribution strategy

Article 313-19 of the AMF GR requires that firms have in place adequate financial instrument governance arrangements to ensure, in particular, "*that the intended distribution strategy is consistent with the identified target market*". Points 49 to 51 of ESMA Guidelines 35-43-620 provide details concerning the due diligence expected of distributors when defining the distribution strategy for their products. Point 49, in particular, states that while the distributor should take the distribution strategy identified by the manufacturer into account, it should nevertheless "review it with a critical look". Points 50 and 51 address possible cases in which the distributor might decide to adopt a more prudent distribution strategy than the manufacturer, or on the contrary a less prudent strategy, provided that in the latter case a thorough analysis should be conducted and this decision to relax the distribution strategy should be reported to the manufacturer.

The aforementioned provisions, although they stipulate the objectives and context governing the distribution strategy, leave ISPs completely free to define it and determine its content. Before any analysis, the task force therefore endeavoured to obtain the definition adopted by the ISP:

- For one ISP, the definition of the distribution strategy links the investment service and the distribution channel to be preferred. For the ISP in question, the procedure specifies that the distribution strategy "*shall also contain all useful details regarding the distribution channels to be used (internet channel and/or branch office channel), and the personnel categories authorised to sell the product*". This linking of the investment service and the distribution channel constitutes a good practice.
- For the other ISPs of the sample group, the distribution strategy is defined as the combination of an investment service and a category of advisers.

For three of the four ISPs in particular, identification of the investment service is performed at the level of their parent Group. On the individual level, these ISPs specify, depending on the case, *i) the accreditations of the employees authorised to sell the product in light of the training they have followed or ii) the population of advisers concerned*.

Regarding the process of definition of the distribution strategy, it was noted that, with the exception of one firm, for group products the ISPs replicate as is the distribution strategies identified by their parent company without "*reviewing it with a critical look*", thereby not complying with Article 313-19 of the AMF GR, in light of point 49 of ESMA Guidelines 35-43-620. Regarding local products, on the other hand, the two ISPs of the sample group concerned define the distribution strategies at their level.

It was also noted that one ISP used marketing tools which can be set to "block" a category of advisers not included in the validated distribution strategy for a product. Advisers belonging to that category are therefore unable to propose the product in question to their clients. This distribution blocking defined in the distribution strategy constitutes a good practice.

### 3.3.2. Monitoring of the distribution strategy

It was noted that four ISPs of the sample group do not perform the review stipulated in Article L. 533-24-1 (3°) of the MFC and mentioned in Article 313-22 of the AMF GR at their local level (i.e. legal entity). This review is performed entirely by their parent company for group products, which is not in compliance with the provisions of the aforementioned articles. The last ISP itself performs the review of the financial instruments to ensure that the planned distribution strategy for each financial instrument remains suitable for its specific situation.

#### **Regulatory reminders:**

- *"The distributor should take the distribution strategy identified by the manufacturer into account and review it with a critical look"* (point 49 of ESMA Guidelines 35-43-620).
- As distributor, perform a review of the distribution strategies (Article L. 533-24-1 of the MFC and Article 313-22 of the AMF GR).

#### **Good practices:**

- Defining a distribution strategy combining both the investment service involved, the distribution channel and the categories of advisers authorised to sell the financial instrument.
- Putting in place an automatic marketing blocking system targeting, for each financial instrument, the categories of advisers who are not authorised by the distribution strategy to sell the instrument in question.

## 3.4. SALES OUTSIDE THE TARGET MARKET

### 3.4.1. Definition of "negative" target markets and the "grey" area

Article 313-19 of the AMF GR stipulates that distributors should identify any group(s) of clients whose needs, characteristics and objectives are not compatible with the financial instrument or service distributed (the "negative" target market). Points 67 to 74 of ESMA Guidelines 35-43-620 specify the due diligence relating to definition of the negative target market and the management of sales performed outside the target market. In accordance with point 67 in particular, to define their negative target markets distributors should apply the same five categories (cf. section 3.2.2 of this document) and principles as those set out in points 34 to 40.

ESMA also gives a reminder that the distributor should refine the "theoretical negative" target market identified where applicable<sup>32</sup> by the manufacturer: although it should take into account the "theoretical negative" target market identified, it should therefore also use information concerning its own client base, to be able to define more concretely the group of clients to which it should not distribute this particular product. Although the distributor is asked<sup>33</sup> to use the same list of categories as that used to define the target market, it nevertheless remains possible for the distributor to opt for the definition of a negative target market by default. In such cases, as outlined by ESMA in point 68 of its Guidelines 35-43-620, the ISP could define the negative target market by stating that the product or service is incompatible for any client outside the positive target market. Moreover, the distributor is asked to avoid sales outside the identified target market. However, a distinction is made by ESMA

<sup>32</sup> In the case of manufacturers subject to the MiFID II provisions

<sup>33</sup> Point 34 of ESMA Guidelines 35-43-620

depending on whether the sale takes place simply outside the target market (i.e. in the "grey area"), or in the negative target market:

- Regarding the "grey area", for example, ESMA states that in certain situations products could be sold there,<sup>34</sup> in certain circumstances and provided that all the other legal requirements are met (including those relating to information, suitability and appropriateness, and the detection and management of conflicts of interest). However, in these cases the distributor is asked to document the reason for the deviation and, where applicable, mention it in the statement of suitability.
- Regarding the negative target market, it is specified that sales in it should be rare.<sup>35</sup> Moreover, it is specified that the justification for the deviation should be accordingly significant and is generally expected to be more substantiated than a justification for a sale outside the positive target market (i.e. in the grey area).

Regarding the identification by the ISPs of the sample group of the "grey area", i.e. groups of clients belonging neither to the group identified in the target market nor to that identified in the negative target market, major disparities were noted by the inspection task force from one firm to another.

With the exception of one ISP, the grey area is covered by no precise definition. Moreover, one ISP stated to the task force that it considered that the grey area consisted of whatever did not come under the positive target market, and thus did not define a negative target market. This practice of not defining the grey area explicitly enables it to keep a wide field open to diversification sales, which is not in compliance with Article 313-19 of the AMF GR.

As a reminder, the grey area is the area positioned between the positive target market and the "negative" target market. Distributors may decide, as part of personalised advice, to recommend financial instruments for which the client belongs to this grey area, for the purpose of diversification. When this area has been defined explicitly, this practice remains in compliance with the regulations.

Regarding the definition of the negative target market, one ISP stipulated in its procedures that financial instruments do not always have one, indicating the possibility, and not the obligation, for the firm to define one if the parent company or the manufacturer has not defined one, which is not in compliance with the provisions of Article 313-19 of the AMF GR. Three ISPs stated to the inspection task force that the negative target market was defined by the negation of the target market. However, no procedure of these three ISPs clearly mentions this definition adopted for the negative target market. Moreover, this definition is in contradiction with the procedures of their parent companies, which define the negative target market as "*clients whose needs and objectives and investor profile are not compatible with the product*". This lack of clear identification of the target markets is not in compliance with the provisions of Article 313-19 of the AMF GR, in light of point 67 of ESMA Guidelines 35-43-620. A fifth ISP, for its part, stated that the identified negative target markets corresponded at least to those of the manufacturers. Now, in practice, this ISP always adopts as is the negative target markets identified by the manufacturers, without analysing their suitability and where appropriate refining or adapting them.

As a reminder, the ISP may either decide to define a negative target market explicitly, or opt for the definition of a negative target market by default (the negative target market in this case consists of whatever is not the positive target market). However, this second option should be stipulated by the ISP's procedures.

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<sup>34</sup> Point 70 of ESMA Guidelines 35-43-620.

<sup>35</sup> Point 71 of ESMA Guidelines 35-43-620.

### 3.4.2. Characterisation of the negative target market

The task force noted numerous shortcomings concerning the characterisation of their negative target markets by the five ISPs inspected:

- Two ISPs assert that they adopt as is the negative target markets defined by the manufacturer, without analysing them, thereby infringing the provisions of Article 313-19 of the AMF GR, in light of point 67 of ESMA Guidelines 35-43-620. Moreover, for one of these ISPs, the task force noted, in the case of the test sample, that no negative target market had been identified by the manufacturer and accordingly by the distributor ISP for the ten financial instruments selected by the task force. This shortcoming concerned both "group" products and "local" products (marketed solely by the firm). This failure to identify negative target markets is not in compliance with Article 313-19 of the AMF GR.
- Three ISPs do not clearly identify negative target markets. These ISPs rely exclusively on the documents provided by their parent company, which does not clearly identify the negative target markets of the financial instruments marketed. Neither the marketing documents provided by the parent companies of these ISPs nor the manufacturer's documents contain information making it possible to conclude on a definition of the negative target markets. This practice is not in compliance with the provisions of Article 313-19 of the AMF GR.

### 3.4.3. Exchanges with the manufacturers and information provided to clients

The distributor is required to report information to the producer relating to sales of financial instruments carried out in the negative target market, so that the manufacturer may in return review the suitability of its theoretical target market. Regarding this point, the task force noted diverse practices of the inspected ISPs. In particular:

- One ISP stressed the fact that the asset management companies with which it worked were not concerned by the regulatory obligation of monitoring of the target market,<sup>36</sup> which implies that this ISP, as distributor, is not required to perform the information feedback mentioned. And yet, this PSI stated to the task force that it responded to any requests received from the asset management companies.
- Four ISPs perform no direct feedback of information to their manufacturers regarding sales in negative target markets. This feedback is centralised and performed on their behalf by their parent company.

Moreover, the distributor should inform clients when a financial instrument has been recommended to them although they are included in the negative target market identified for that financial instrument.<sup>37</sup> Regarding this point, the task force likewise noted diverse practices of the inspected ISPs. In detail:

- One ISP stated that it sends a warning message to the clients concerned, for a transaction excluding investment advisory services, if one of the client's product governance criteria belongs to the negative target market of the security, which constitutes a good practice.
- A second ISP stated to the inspection task force that it does not inform the client in the case of a sale outside the target market, specifying that it has no dynamic tool enabling it to detect such sales at the

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<sup>36</sup> Applicable to manufacturers

<sup>37</sup> Point 55 of ESMA Guidelines 35-43-620



time when they are performed. This is not in compliance with point 55 of ESMA Guidelines 35-43-620, in the case of a sale in the negative target market.

- The procedures do not stipulate this information provided to the client for three of the five ISPs inspected, which means it is not possible to comply with point 55 of the aforementioned ESMA guidelines.

**Regulatory reminder:**

- Explicitly identify any groups of clients whose needs, characteristics and objectives are not compatible with the financial instrument or service distributed by the firm (Article 313-19 of the AMF GR).

**Good practice:**

- Informing the client with an automatic warning message, when for him, one of the criteria relating to the financial instrument governance belongs to the negative target market of the financial instrument, even though a recommendation has been sent to the client.