MFSA MALTA FINANCIAL SERVICES AUTHORITY

17 October 2024

Dear Chief Executive Officer,

Dear Compliance Officer,

## MFSA Expectations in the Context of the Distribution of Local Bond Issues by Investment Firms and the Corresponding Product Oversight and Governance practices

You are receiving this letter as the Chief Executive Officer and Compliance Officer of an investment firm supervised by the Malta Financial Services Authority (referred to herein as the 'MFSA' or the 'Authority').

### BACKGROUND

The MFSA endeavours to stimulate compliance with applicable rules governing investment services licensed entities (also referred to herein as "licensed entities", or "investment firm/s") for a fair, honest, and transparent financial market, which in turn strengthens confidence within same market, with the aim of protecting investors. To this end, the Authority's supervisory activities are aimed at attaining high compliance standards within the supervised licensed entities using diversified tools encompassing investigations, mystery shopping exercises, thematic reviews, off-site work, supervisory meetings, and on-site inspections.

A supervisory review[1] undertakes an in-depth analysis of the risks and issues identified which tend to have wider implications on the financial services market. By investigating specific key issues in detail, a supervisory review provides meaningful comparisons. The scope of this letter is to provide further guidance to licensed entities on how certain issues regarding the distribution of local bond issues (hereinafter also referred to as "local bond selling practices"), should be tackled adequately in line with the applicable rules and regulation. For the purpose of this supervisory review, the Authority also adopted a look through approach and has also

[1] For the sake of clarity and consistency, the scope of this supervisory review is related to the sale of local issues sold on the Prospects Market and securities having distinctive characteristics, with part independently of the process used by each investment services firms.

assessed the firms' compliance with the applicable Product Oversight and Governance requirements, (also referred to herein as ''POG arrangements'' or ''POG'') as applied during this process.

This letter provides an insight on the identified observations and highlights both good and bad practices observed by the Authority. The MFSA expects that all investment firms undertake an in-depth gap analysis of the outcomes included herein. It is imperative that all investment firms take the necessary actions to ensure that their POG arrangements and selling practices are in line with the applicable guidelines, rules, and regulations.

**METHODOLOGY**

Investor protection continues to be one of the Authority's ongoing supervisory priorities.[2] Adequate selling practices and robust POG arrangements are two crucial elements which contribute to ensuring that during all stages of the investment products' life cycle, investment services providers act fairly and professionally in their clients' best interest and make sure that products are not mis-sold.

This supervisory workstream was initiated by the Authority in the end of 2020, with follow-up meetings held during the year 2023. The workstream focused on the selling practices of local financial instruments on the Malta Stock Exchange or on the Prospects Multilateral Trading Facility (also referred to hereinafter as ''Prospects MTF'') and the compliance controls in place to ensure that such financial instruments have been sold in line with requirements outlined in the respective prospectus or admission document respectively. Within the scope of these interactions, licence holders were subject to an assessment on the distribution of issues having distinctive characteristics (e.g., instruments falling under the Bank Recovery and Resolution Directive, high risk and illiquid securities). Moreover, the scope of the supervisory review also looked through the POG arrangements to assess investment firm's awareness and the status of application in line with Chapter 2 of the Conduct of Business Rulebook.

The Authority carried out an assessment of the distinctive characteristics pertaining to the financial instruments and the number of investment firms that distributed these instruments during the reference period (2020&2021). In fact, the methodology was structured in a way to include a combination of investment firms that registered high distribution numbers when it comes to the Prospects MTF and to ensure that the distribution was done on advisory basis. The Authority also took into consideration the distribution to retail clients who are older than sixty-five years of age and the respective risks being attributed to these types of clients.

The list of the Malta Stock Exchange members issued for the year 2020 was considered by the Authority to determine the sample of the investment firms to be considered for this supervisory review. In total a sample of five (5) licence holders was chosen out of seventeen

[2] Supervision Priorities 2023

(17) members which is deemed to be a representative sample, given that this sample represents in total thirty percent (30%) of the local market.

In view of the COVID-19 pandemic, supervisory meetings were carried out remotely during 2020 and 2021. However, subsequent follow-up meetings were held at the MFSA's premises. The Authority informed the selected investment firms of the upcoming supervisory meetings by means of an official letter and requested certain documentation related to the subject matter. The supervisory interactions were carried out by the investment services team within Conduct Supervision.

A pre-established procedure of supervisory interactions was followed. In fact, following the completion of this supervisory workstream, the Authority carried out an assessment of the documentation provided, and post-supervisory letters were sent to the respective investment firms. During the end of years 2020 and 2021, the Authority inspected the selected licensed holders and reviewed a sample of client files. Post-supervisory letters were sent to the respective sampled entities outlining the major shortcomings which needed to be rectified.

During 2023, the Authority conducted physical follow-up meetings to assess whether there were any improvements in relation to the findings emanating from the Authority's publication: The Nature and Art of Financial Supervision - Volume V - POG Requirements issued on 16th July 2021 and in view of the European Securities Markets Authority's (ESMA's) publication: ESMA Final Report - Guidelines on MiFID II Product Governance Requirements. Furthermore, the Authority carried out an assessment of the documentation provided, and post-supervisory letters were sent to the respective sampled licensed entities outlining the main shortcomings to be rectified. The Authority is issuing this *"Dear CEO letter"* to outline the common shortcomings identified during the supervisory interactions held in 2020, 2021 and 2023.

**KEY FINDINGS**

## *A. Marketing Material*

The Authority understands that the distribution of marketing material on local security bond issues is key to attract investment. As part of this supervisory review the Authority requested the investment firms to provide copies of the marketing material issued with respect to recent local issues. In some instances, licensed holders have informed the Authority that the material being issued is for information purpose only and does not offer an investment advice.

**[i]** ***Information/ Advertising material related to a recent local security issue.***

*Regulatory Requirements and Guidelines*

In line with Rule R.1.2.22 of the Conduct of Business Rulebook, whenever, an investment firm would like to issue a communication to inform the market on the upcoming local security issues, the investment firm is required to conduct an assessment of the medium being

selected to advertise a particular security being issued. The assessment should consider the following factors: the nature of the Product or Service, the extent of the information being provided, the risks involved, and the risks profile of the target audience.

In accordance with Rule R.1.2.23 and the supporting Guideline G.1.2.8 of the Conduct of Business Rulebook, whenever an investment firm is disseminating any information/ advertisement, a statement should be included outlining the identified target market to whom the contents of the website or email is being addressed to. With respect to the information/advertisement being presented on the website, the investment firm should also include an appropriate statement that the client is leaving the Company's website and accessing another website, whenever the licence holder's website is hyperlinked to other websites.

It is imperative to note that the Compliance Officer must approve all advertisements issued by the investment firm in line with Rule R.1.2.10 of the Conduct of Business Rulebook. The Compliance Officer must assess whether the material being issued is for information purposes or else constitutes as an advertisement per se. Furthermore, the Compliance Officer has an obligation to ensure that the content being approved is in line with the applicable Conduct of Business Rules.

*Key Findings*

Prior to the issuance of the security, most of the licensed holders opted to send out either an email or an SMS to advertise the issue of a particular security. In certain cases, the SMS included a hyperlink leading to the investment firm's website for further information.

The Authority noted that some investment firms did not conduct an assessment to ensure that the medium selected for this purpose is commensurate with the nature of the product/service being distributed. Furthermore, it was noted that not all investment firms have in place a distribution system which distinguishes, at onboarding stage, the respective client's preference of the medium through which to receive marketing information.

In certain instances, the Authority noted that certain investment firms would be sending information on the upcoming local issue through mass submissions to all clients. The Authority expects that an investment firm sends information only to those clients who meet the identified target market as opposed to sending the information through mass submission to all clients.

*Expectations*

Whenever investment firms are marketing any financial instruments, they should provide all the necessary information about the product to enable the client to make an informed decision. In view of this, investment firms should ensure that the necessary measures are undertaken to ensure such clients are not being misled by their marketing campaigns. The Authority expects that investment firms assess the medium or channel being selected prior

to issuing any information/advertisement. On the other hand, the Authority deems that a mass dispatch approach, whereby, for example, a mailshot is sent to all the clients of an investment firm, irrespective of their risk profile or their knowledge and experience, is not a favourable practice. Ultimately, it is crucial that investment firms have in place an adequate distribution system outlining the clients' medium of communication.

### *B. POG Policies and Procedures*

The Product Oversight Governance (POG) policies and other related procedures are relevant as these assist investment advisers in the product selection process, especially to understand and characterise their products accordingly. Such policies and procedures would facilitate the investment firm's decision-making process in selecting the products that are suitable for the respective clients. The Authority carried out an analysis of the documentation provided by the sampled licensed holders to assess the extent to which such policies and procedures are in line with the applicable rules, regulations, and guidelines.

#### *[i] Product Oversight Governance Policies*

*Regulatory Requirements*

Guideline G.4.4.5 of the Conduct of Business Rulebook emphasises that licensed entities should provide mandatory training to its investment advisors on the features and characteristics, including potential risks, of the products offered by the investment firm, including new ones.

The ESMA Guidelines on MiFID II Product Governance Requirements outlines that the granularity of the cluster sampling is key. Paragraph 47 under Section 5.3 outlining the Guidelines for Distributors (also paragraph 27 under Section 5.2 applicable to manufacturers)[3] outline that if products having sufficient comparable product feature, a common approach can be adopted and grouped together. Such guidelines must be taken into consideration by the investment firms whilst conducting the Target Market Assessments.

However, it is imperative that investment firms should also consider the complexity of the product per se. Therefore, the more complex the product becomes, the more granular the clustering should be. In certain instances, due to the complexity of the product, the clustering approach would not be suitable and investment firms should opt for defining the target market at the level of the individual product. Once a clustering approach is adopted for a particular target market, such assessment should be sufficiently granular; to avoid the inclusion of any

[3] Section 5.2 outlining the guidelines applicable for Manufacturers were transposed in points 2.4 – 2.7 of Appendix 1 of Chapter 2 of the Conduct of Business Rulebook.
Section 5.3 outlining the guidelines applicable for Distributors were transposed in point 6.5 of Appendix 1 of Chapter 2 of the Conduct of Business Rulebook.

group of investors whereby their needs, characteristics, and objectives would be incompatible with the respective product.

*Key Findings*

From the assessment undertaken, the Authority noted some common shortcomings in the POG policies and procedures. For instance, the POG policies provided did not include a dedicated section on how the investment firm intends to train its staff on its POG arrangements as expected by Guideline G.4.4.5, as outlined above.

In the context of cluster sampling referred to above, one investment firm updated its policies, in view of the implementation of the ESMA Guidelines issued in 2023 and has included a section in its POG policy dedicated to cluster sampling. The investment firm in question outlined the benefits of adopting such an approach and the main factors being considered such as: *''product similarities''*, *''risk profiles''*, *"market segmentation"*, *"regulatory requirements"* and *''strategic objectives''*. However, the Authority noted that the investment firm's approach to cluster sampling was very brief, and the aforementioned factors were not assessed in depth.

*Identified Good Practice*

In view of the ESMA's Guidelines on MiFID II Product Governance requirements published in 2023, the Authority noted that certain entities have updated their policies and procedures, whilst others were in the process of updating them. For instance, an investment firm has carried out a detailed compliance analysis outlining whether the policies and procedures are in line with the new requirements.

*Identified Bad Practices*

It was noted that one investment firm had in place several policies related to its POG arrangements rather than an overarching POG policy incorporating all the requirements. The Authority expects that licensed holders should have in place one POG procedure covering all the relevant matters which staff can refer to, for further guidance.

In another instance, the Authority noted that the POG policy provided was very generic. The procedure included references to the various rules, regulation, guidelines, and circulars issued by the MFSA or the ESMA. However, the policy did not include reference to the business model and the process of how the POG arrangement is being implemented by the investment firm.

*Expectations*

The Authority expects that investment firms train all their investment advisors, on the Company's POG policies and procedures, at least on an annual basis. Such training is beneficial to ensure that investment advisors understand and follow the firm's policies and procedures in this important area – thereby ensuring that the right products are distributed to the right clients.

In general, however, whenever new guidelines, rules, and regulations would be introduced, the Authority would recommend that investment firms should carry out a detailed gap analysis rather than a compliance analysis. The scope of the gap analysis is to outline the current state of compliance vis-à-vis the desired state of compliance. The Compliance Officer should also include an action plan of how the desired state of compliance would be achieved by the investment firm.

### *[ii] Target Market Procedure (including Negative Target Market) within the Product Oversight Governance Policies*

*Regulatory Requirements*

Reference is made to rule R.2.34 of the Conduct of Business Rulebook, whereby investment services entities acting as a distributor are obliged to obtain sufficient information from the manufacturer to understand the product that they intend to distribute. Investment firms acting as distributors are to ensure that the products will be distributed in accordance with the needs, characteristics, and objectives of the identified target market. Hence, the information obtained from the manufacturer should be used in conjunction with other available information on their own clients to identify the target market and distribution strategy.

Point 1.5 of Appendix 1 of Chapter 2 of the Conduct of Business Rulebook provides further guidance on the five main categories which should be taken into consideration when identifying and subsequently formulating the target market, namely:

i) The type of clients to whom the product is targeted, whether the financial instrument is being targeted to *"Retail Client," "Professional Client"* and/or *"Eligible Counterparty"* in accordance with MiFID II Directive 2014/65/EU.

ii) Knowledge and experience possessed by the targeted client to understand the financial instrument.

iii) Financial situation with a focus on the ability to bear losses, whereby the percentage of losses and/or any additional payment obligations should be made.

iv) Risk tolerance and compatibility of the risk/reward profile of the product with the target market which should take into consideration the risk attitudes such as *"risk oriented", "speculative", "balanced"* and *"conservative"*.

v) Clients' objectives and needs which consider their investment objectives and the needs of the targeted clients when investing.

*Key Findings*

The Authority assessed how the sampled licensed holders tackle the issue of sales in the negative target market within the POG procedures. From the assessment undertaken, it can be concluded that the procedures would very often be generic in nature whereby investment

firms would define the concept of the negative target market, the criteria being considered, and the function responsible for authorising the sales in the negative target market or outside the positive target market. Generally, the negative target market criteria did not consider the type of client, the nature and complexity of the product (including the risk-reward profile), as required by point 14.3 of Appendix 1 of the Conduct of Business Rulebook. A major shortcoming identified is that the target market procedure did not make it clear that the sales into the negative target market should be a rare occurrence.

As part of the Target Market formulation, investment firms make use of various platforms as their source of information. However, the procedures provided did not include a dedicated section outlining how and which data/information is being obtained to gain the necessary understanding and knowledge of the products. The inclusion of such section would be beneficial for the investment firm to ensure that all the necessary data/information have been factored and that the product that the investment firm intends to recommend, or sell would be compatible with the identified target market.

*Identified Bad Practice*

From the supervisory interactions held, it has emerged that in certain entities the Compliance Officer was not involved, even from an internal control perspective in the approval of the sales being made into the negative target market. It was noted that the decision of whether clients falling within the negative target market can proceed with the investment or otherwise was being left to the advisors' discretion.

The Authority considers that such investment firm did not apply proper governance processes with respect to the application of this assessment. Besides, the Authority expects that the content of paragraph 72 of the Guidelines on MiFID II product governance requirements, as transposed in point 11.5 of Appendix 1 of Chapter 2 of the Conduct of Business Rulebook, which relates to the regular review by both manufacturer and distributor to assess whether products and services are reaching the target market is duly applied, and the Compliance Officer is involved.

*Expectations*

It is imperative to note that POG procedures should always be tailored to the investment firm's needs and must be a true reflection of the POG process that is being followed by the investment firm. Hence, this would in turn facilitate the investment firm's decision-making process in selecting suitable financial products for their clients.

The Authority would like to remind all licensed holders that the POG policies and procedures should be updated in line with the ESMA Guidelines on MiFID II product governance requirements. On 19th October 2023, the Authority has issued a Circular outlining the main revisions to the Conduct of Business Rulebook.

It is also expected that investment firms are always required to define definitions/terminologies in granular detail both within the TMAs and the POG policies.

***[iii] Procedure on Vulnerable Clients***

In certain cases, clients might possess some type of vulnerability which hinder their financial decision making when buying a financial product. The main characteristics of a typical retail investor investing in such type of bonds is generally over sixty (60) years old and would typically lack financial literacy skills. Through its supervisory remit, the Authority aims to protect the interests of such vulnerable clients.

*Regulatory Requirements*

Reference is made to rule R.4.4.16 of the Conduct of Business Rulebook whereby investment firms are required to implement policies and procedures to enable them to collect and assess all information necessary to conduct a suitability assessment for each client. Moreover, point 3.7 of Appendix 7 of Chapter 4 of the Conduct of Business Rulebook provides further guidance on the information to be collected especially with respect to potentially vulnerable clients.

Reference is also made to Guideline G.4.2.9 of the Conduct of Business Rulebook, whereby entities are expected to outline in detail their processes (such as complex telephone menu systems and automated services, with limited or no possibility for human interaction) to ensure that the entity's actions or processes do not lead to an adverse outcome for vulnerable clients.

Furthermore, in terms of Guideline G.4.2.10 of the Conduct of Business Rulebook, investment firms are expected to adopt cautious practices in their day-to-day operations to ensure that the interests of vulnerable clients are adequately safeguarded by the investment firm. For instance, an escalation procedure which is endorsed by senior management to adopt different terms and conditions and the provision of regular training to client facing personnel are deemed to constitute a prudent approach to vulnerable clients.

*Key Findings*

Investment firms must ensure that vulnerable clients are treated fairly. Following an assessment of the procedures on vulnerable clients provided, the Authority noted that most of the investment firms did not undertake a detailed assessment of how their processes can impact their vulnerable clients. Furthermore, the Authority also noted that investment firms would list various cautious practices which are deemed to be very generic. It was also noted that, investment firms did not outline how complex telephone systems and automated services with limited or no possibility for human interaction can impact vulnerable clients who may wish to contact the investment firm for further information.

*Identified Bad Practices*

It has been noted that an investment firm did not have in place a detailed procedure on vulnerable clients, and hence did not meet the expectations outlined in Guidelines G.4.2.8 – G.4.2.10 of the Conduct of Business Rulebook. Therefore, nor could its procedures be considered to fully align with the requirements of Rule R. 4.4.16 of the Conduct of Business Rulebook.

In other instances, the procedure on vulnerable clients was very brief and such procedure directed the client facing personnel to refer to the Conduct of Business Rulebook. The Authority expects that such procedure should be adapted to the investment firm's business model.

*Expectations*

It is imperative that all licensed entities understand the needs of vulnerable clients and undertake the necessary changes to effectively respond to the vulnerable clients' needs by enhancing the investment firm's process and/or adopt more cautious practices.

#### *[iv] Updates of the Version Control*

*Key Findings*

The Authority noted that the policies and procedures provided by the investment entities included an updated log recording revisions made to the respective policies and procedures. However, such version log does not outline in granular detail whether the policy has been initially drafted or else whether there were any updates to the respective policies and procedures.

*Expectation*

Although, the Rules do not specifically prescribe a version control log, it is deemed to be best practice that each of the investment firm's policies, including the POG policy should show a record of the exact date of the last amendment thereto and the respective version of the policy so that licensed entities can keep a proper audit trail of the amendments that were carried out during the year.

### *C. Target Market Assessment (TMA)*

As part of the POG arrangements, investment firms are obliged to identify a target market for the respective financial instruments which they offer to clients. In fact, the TMA should consider the risks and characteristics of both the financial instrument in question. and the clients. As part of this workstream, the Authority assessed the granularity of the Target Market Assessment being prepared by the investment firms.

***[i] Identifying the Target Market***

*Regulatory Requirements*

Reference is made to paragraph 42 of the Guidelines on MiFID II product governance requirements, which outlines that distributors should use the same list of categories used by manufacturers as a basis for defining the target market for their products. This guideline is transposed in point 6 of Appendix 1 of Chapter 2 of the Conduct of Business Rulebook. Investment firms acting as distributors should also define the target market on a granular level and should consider the following important elements namely: type of clients being serviced by the investment firm, the level of detail of information gathered from clients, the nature of the products and the type of investment services being provided.

Point 1.5 within Appendix 1 of Chapter 2 of the Conduct of Business Rulebook *(which replaces the previous rule R.2.19 and the corresponding rule R.2.53, as applicable)* requires licensed entities to provide more granular details with respect to the potential financial losses. Investment firms are also required to specify the percentage of losses to the target clients to ensure that such clients would be able and willing to sustain such losses. The TMA should also include specification whether there will be any additional payment obligations.

*Key Findings*

When it comes to outlining the tolerance for loss, some investment firms did not take into consideration the percentage of loss that a typical client is able to bear. Similarly, in a few cases, the financial product features did not include the percentage of loss that the target investor should be able and willing to afford such as for instance, minor or total loss, and any additional payment obligations that might exceed the amount invested by the typical client, such as a margin call.

The Authority noted that local bond issues are heavily distributed to customers that are sixty (60) years of age and over. It is imperative that the age of the client is adequately considered, and the necessary explanations (where required) are provided to ensure that clients falling within such an age bracket are aware of the features and risks of the bond issue being discussed.

*Identified Good Practice*

All sampled licensed entities undertook a risk appetite assessment on whether they will accept to act intermediaries for the distribution of bond issue at hand, or possibly to act as sponsoring stockbrokers to the bond issue itself. The assessments include analysis of the financial history of the issuer and the specific market characteristics.

If there is interest to participate, the investment firms would hold meetings with respective issuers for the financial advisors to understand better the features of that local bond issue

and to be trained accordingly. All licensed entities make available to their investment advisors, information papers to assist them in better understanding the product at hand.

*Identified Bad Practice*

In certain instances, the Authority also noted that the type of service/mode of distribution (e.g. advisory or non-advisory) was not being included in the TMA, instead this was only reflected at the stage of the suitability assessment carried out by the licensed holder. Hence, this approach has proved difficult for the Authority to determine the mode of distribution in the TMA provided to the Authority as part of this exercise. It is important that the mode of distribution is identified during the target market assessment to clearly outline what services will be provided for the respective investment/asset class being considered by the investment firm.

In another instance, the Authority noted that certain sales were made through a mode of distribution which was different to that established at target market assessment stage. For instance, a financial instrument was initially set to be sold under advisory and discretionary portfolio management services, was also sold through a non-advisory service.

*Expectations*

Licensed holders are expected to have in place adequate controls to ensure that bond issues are being distributed through the appropriate distribution channel. Proper internal controls reduce the risk of mis-selling. Moreover, clients of a certain age group are more prone to vulnerability, and this feature is expected to be carefully addressed by all investment firms when carrying out a target market assessment. Please also refer to our comments in section B of this letter above.

The Authority expects all licensed holders to have sufficiently granular TMAs, to properly identify and define the type of client/s that can invest/s in these securities. Moreover, it is expected that investment firms should be always consistent and do not deviate from the mode of distribution (e.g. advisory, non-advisory and portfolio management) chosen initially at the target market assessment stage. Such approach would ensure that the investment firms would limit the risk of selling the financial instrument to a client who does not have the necessary knowledge and experience to clearly understand the risks of that instrument.

***[ii] Definitions and Terminologies Used in the Target Market Assessment***

*Regulatory Requirements*

As per paragraph 42 of section 5.3 of the ESMA Guidelines mentioned above, which is also transposed in point 6 of Appendix 1 of Chapter 2 of the Conduct of Business Rulebook, "*distributors should define the target market on a more concrete level and should take into account the type of clients they provide investment services to, the nature of the products and the type of investment services they provide and the level of detail of information gathered from*

*clients. In this context, distributors should ensure that the concepts used for the definition of the actual target markets for products are aligned with the concepts used in the context of the suitability and appropriateness arrangements*".

Therefore, the terminologies/definitions used by the investment firms should be clearly defined, in both the TMA and the firm's POG policy to avoid any misinterpretation or leave any room of subjectivity, especially by the firm's client facing personnel.

*Key Findings*

The time horizon terminologies being used in target market formulation reviewed by the Authority, such as: *"short term"*, *"medium term"* and *"long term"* were not granularly defined to distinguish the respective period being taken into consideration. Moreover, the Authority noted that the terminologies used such as *''sufficient experience"* and *"understand risks involved"* were not granularly defined to outline the different level of knowledge and experience expected by the retail client to qualify for that type of investment.

The complexity, nature and the risks posed by the financial products might be detrimental to the retail client due to the lack of knowledge and experience. When it comes to the risk tolerance criteria being considered, terminologies related to risks such as for instance: *"moderate risk capacity"*, *''aggressive risk capacity"*, *"moderate risk appetite"*, *"aggressive risk appetite"* were not defined by the investment firms. Similarly, terminologies related to income and liquidity was not granularly explained such as for instance: *"income moderate"*, "*income aggressive"*, "*low liquidity needs"*, and "*medium liquidity needs"*.

*Expectations*

Investment firms, acting as distributors are expected to define the target market on a more granular level than the manufacturer. Besides, the investment firm's client facing personnel should be also guided on the way the financial product in question will be offered to the client. From the assessment undertaken, it can be concluded that the sampled entities use generic definitions/terminologies in the TMA.

Overall, the above-mentioned definitions/terminologies are deemed to be subjective as these are subject to various interpretations by different investment advisors. The Authority expects that the investment firms should strike the right balance between the granularity and practicability of the TMA. All license holders are requested to re-assess their TMAs and ensure that such assessments adequately satisfy the relevant requirements outlined above.

***[iii] Negative Target Market Assessment***

*Regulatory Requirement*

In accordance with point 14 of Appendix 1 of Chapter 2 of the Conduct of Business Rulebook, investment firms acting as distributors should also consider the information available on their

client base. As a result, the investment firms would be in a better position to outline the opposing characteristics which make up the negative TMA.

*Key Findings*

As part of the TMA, the investment firms are obliged to consider whether there are characteristics of the financial instrument which are incompatible with certain type of clients. The Authority noted that the sampled investment firms did not outline characteristics of the negative target market and the section relating to the negative target market in the product oversight and governance assessment document would be left blank or be listed as NIL.

Furthermore, the Authority noted that certain investment firms included a description of the negative target market, but such description was very brief and did not consider the following factors, such as: time horizon, the client type, the nature, and the complexity of the financial instrument (which should include the risk – reward profile).

*Identified Bad Practice*

The Authority is concerned to note that sales to clients that fall within the negative target market were not being approved by the Compliance Officer but were in certain instance being approved by another department within the investment firm. It was further noted that such sales were not being disclosed and presented to the Board of Directors in the subsequent compliance reports for the reporting period. The Authority expects that the licensed holders should follow the requirements as outlined in point 10.4 of Appendix 1 of Chapter 2 of the Conduct of Business Rulebook for sales emanating from the negative target market which requires the sales of Products into the negative target market to be disclosed to the client, even if those sales are for diversification or for hedging purposes. Moreover, the distributor is required to ensure that, even if done for diversification purposes, sales into the negative target market should be a rare occurrence.

*Expectations*

In terms of Point 10.4 of Appendix 1 of Chapter 2 of the Conduct of Business Rulebook, investment advisors are generally, not allowed to sell instruments to clients that fall within the established negative target market. However, in certain instances where such investment advisors are allowed to do so, specific approval is expected to be obtained from the Compliance Officer on the basis of Rule R.2.104 which requires that "*Distributors shall ensure their compliance function oversees the development and periodic review of Product governance arrangements in order to detect any risk of failure to comply with the obligations set out in these Rules.*" Accordingly, the Authority expects the Compliance Officer to be involved (even from an internal controls' perspective) in the approval of any sales being made into the negative target market and to sign off such decisions.

The Authority emphasises the importance of the inclusion in the TMA of all relevant information outlining the characteristics of the financial product. A granular TMA would assist

the client facing personnel to have a better understanding of the characteristics of the financial product and the respective segment from the entity's client base to whom the product should not be sold.

### D. Investment Committee Meetings

*Regulatory Requirement*

Reference is also made to, Guideline 4 of the *ESMA Guidelines on certain aspects of the MiFID II compliance function requirements*, which have been transposed in R1-1.5.3.2. of Part BI: Rules Applicable to Investment Services Licence Holders which qualify as MiFID Firms whereby investment firms should ensure that the compliance function is involved in all significant modifications of the organisation of the firm in investment services, activities, and ancillary services. This would also include the decision-making process when new financial products that are being approved.

Point 9.4, Appendix 7 of Chapter 4 of the Conduct Rulebook obliges investment firms to carry out an assessment of the cost and complexity concerning the financial products which could be done on a higher level, such as for instance, in an investment committee.

*Key Findings*

The Authority has noted, in many cases, once the TMA is prepared, it is the normal practice that, where an investment committee is in place, a formal investment committee meeting is held to discuss and approve the financial product for distribution.

In view of this, the Authority requested copies of the investment committee meetings held concerning the distribution of the local securities on the MTF and on other platforms. From the assessment carried out, it was concluded that the investment committee meeting minutes, presented to the Authority, were very generic in nature and do not outline whether the other members of the committee (including the Compliance Officer) would have put forward any feedback or challenge the committee on the particular security being discussed.

In another instance, the Authority could not find reference to discussions held with respect to the investment parameters which were to be applied to the respective financial instruments.

However, the Authority is concerned to note that not all sampled licensed entities have a committee in place to formally approve the products being distributed.

*Expectations*

The Authority expects investment firms to have a committee, such as an investment committee, in place to formally approve the products they intend to distribute. Such decisions should be taken collegially at higher levels and not by single individuals.

Where firms have an investment Committee in place, the Authority expects all members of the committee participate and offer challenge to proposals set out during committee meetings and that this should be also reflected in the detailed minutes to ensure that there is an audit trail of decisions being taken at investment committee level. Going forward, licensed holders are required to ensure that this regulatory requirement is effectively implemented.

## *E. Selling Practices*

*Regulatory Requirement*

In terms of R. 4.1.5 of the Conduct of Business Rulebook, during their course of operations, investment firms are always obliged to act honestly, fairly and in accordance with the best interest of their clients. Investment firms must behave with utmost good faith, integrity, due skill, care, and diligence vis-à-vis their clients and place the interests of those clients before all other considerations.

Furthermore, R.4.1.6 required investment firms to monitor the performance management, employee development and reward programmes incentivising staff members to ensure that the way an investment firm remunerates or assesses performance of its staff does not conflict with its duty to act in the best interests of its clients. In particular, R.3.16 of the Conduct of Business Rulebook outlines that the relevant persons shall not be remunerated have their performance assessed in a way that it conflicts with the investment firm's duty to act in the best in the clients.

Rule R.4.1.24 of the Conduct of Business Rulebook further provides that investment firms are obliged to record in a durable medium all relevant information related to relevant face-to-face conversations with clients. The information recorded is at the discretion of the investment firms but shall include at least the following:

a) Date of meeting;
b) Location of meeting;
c) Identity of the attendees;
d) Initiator of the meeting;
e) The reason as to why the meeting was held; and
f) Other relevant information about the order.

Investment firms are obliged to disclose a description of the provision of services or ancillary services being provided, as further indicated in Rule R.1.4.19 of the Conduct of Business Rulebook and the applicable corresponding sub-sections (b), (c) and (d).

*Key Findings*

From our supervisory interactions conducted and further analysis carried out from the various client files selected; the Authority is concerned to note instances whereby some of the local

bond issues appeared to executed via the execution only services route rather than the investment advice route, as per the requirements stipulated with the admission documentation respectively. The Authority has requested the entity in question to (a) re visit such sales and ensure that no mis-selling has occurred and (b) to implement the necessary controls to avoid a recurrence of such incidents in the future. In other instances, the Authority noted that no suitability assessment was found in the respective client files selected. Investment firms must ensure that no personal recommendation is made where an execution only service is being provided. Moreover, the Authority expects that the Compliance Officer undertakes robust checks in this regard. Such compliance checks would ensure that the necessary records evidencing the basis on which the service was provided are in place and confirm that the respective clients fall within the target market identified by the investment firm.

*Identified Good Practice*

In general, licensed holders have in place parameters which are internally set within their Client Management Systems and decided at investment committee level relating to sales of instruments. These parameters range from the allowable distribution mode to minimum and maximum allocation of funds from the clients' portfolio.

In the case of an investment firm acted as a sponsoring broker for a particular bond issue, the Authority noted that one of the variable elements of remuneration given to its investment advisors was based on sales. In view of Rule R.3.16 of the Conduct of Business Rulebook, the Authority requested further clarifications on the approach being undertaken by the investment firm. Although, the investment firm was paid a commission for the respective subscriptions, the investment advisors were not given any target sales or budgets for this bond issue. Several remuneration practices were employed by the investment firm to ensure that its interests are aligned with the clients' interest, such as for instance:

i. During the initial public offering (IPO), the Compliance Officer undertook the necessary checks to assess whether the investment advisors acted honestly, fairly, and professionally in accordance with the best interests of the client. Such checks revolved around the actual transactions being undertaken and the suitability reports being compiled for the respective clients.
ii. An internal restriction related to the sale of a specific instrument was placed with respect to certain portfolios, to ensure that the client continues to benefit from appropriate diversification on a portfolio approach basis.
iii. The investment firm confirmed in writing that the variable remuneration received by investment advisors is not linked to a product specific target or a campaign.
iv. The investment committee approved the list of eligible investment instruments that investment advisors can offer.
v. A measure was put in place to prevent investment advisors from buying and selling to "*churn or for instance generate additional activity*" such as for instance the case of re-balancing or profit-taking positions due to favourable market conditions. In this regard, the compliance monitoring plan included a dedicated section related to the event of

mis-selling, whereby the investment firm would reserve the right to claw back any commission paid to the employee amount resulting from any such instance.

vi. The remuneration structure employed by this investment firm ensures that the ratio between the fixed and variable components of remuneration are appropriate whilst considering the best interest of the client.

Although, the above remuneration practices are outlined as a good practice, the Authority strongly recommends that reference should always be made to the ESMA Guidelines on certain aspects of the MiFID II remuneration requirements, given that investment firms are obliged to define an appropriate criteria to align the interests of the relevant persons and that of the firm with that of their clients.

*Identified Bad Practice*

In one instance, the Authority noted that the purchase order form contained information partially completed electronically, whilst other sections were written in wet ink. The Authority expects that the necessary training is provided to the individuals who are responsible for compiling documentation used to service clients. The licence holder must ensure that such documents are being compiled in a comprehensive and suitable manner. Furthermore, it is imperative that employees completing such forms be consistent when carrying out this task and ensure that they fill in all sections within the form (either completely in wet ink or else completely in electronic format). The Authority expects that any changes carried out to the investment firms' and/or client's documentation which are completed in wet ink, should be at least initialised by the respective person carrying out the necessary change, for record keeping purposes.

*Expectations*

Investment advisors, who act as the main point of contact for their clients, are expected to understand the main implications of the transaction to be provided on an execution only basis rather than providing investment advice. Furthermore, the Authority expects that investment advisors must also clearly retain detailed file notes in place detailing the conversations held with the respective clients. The Authority expects that all entities have adequate controls to ensure that the selling of financial instruments is done in accordance with the applicable rules and legislation.

The Authority further expects that the investment firm's remuneration policy should clearly outline both qualitative and quantitative elements, whilst also taking into consideration of acting in the best interest of the clients. In view of this, the necessary compliance checks should be undertaken by the Compliance Officer to ensure that the investment firm is abiding with the pre-established criteria in the remuneration policy when selling these financial products and as such any conflicts of interest are being avoided or at least effectively mitigated on an on-going basis.

## *F. Compliance Matters and Other Reporting Obligations*

The Compliance Officer has a fundamental role to play in ensuring compliance with the applicable rules, regulations, and guidelines on POG arrangements. The Authority expects that the Compliance function acts as a central point of reference for the implementation of the investment firm's POG process. The Compliance Officer is also expected to carry out checks with respect to the investment firm's POG arrangements and integrate the respective findings in compliance reports tabled to the Board of Directors. However, the Authority noted various discrepancies throughout the analysis carried out.

### *[i] Compliance Monitoring Programme*

*Regulatory Requirements*

Reference is made to Article 22 of the MiFID II Regulation 2017/565 which outlines in a comprehensive manner the compliance obligations of investment firms. In fact, Article 22 (2) of the MiFID II Regulation, states that the compliance function shall conduct an assessment based on which it shall establish a risk- based monitoring programme that takes into consideration all areas of the investment firm's investment services, activities, and any relevant ancillary services, including relevant information gathered in relation to the monitoring of complaints handling. Guideline 1 on the compliance risk assessment and Guideline 2 on the monitoring obligations of the compliance function from the ESMA Guidelines on certain aspects of the MiFID II Compliance Function requirements provide further guidance to Article 22 of the MiFID II Regulation 2017/565. The monitoring programme should establish priorities determined by the compliance risk assessment ensuring that the compliance risk is comprehensively monitored.

***Key Findings***

From the assessment undertaken, it can be concluded that the Compliance Monitoring Programmes (CMPs) provided were quite generic in nature and did not include the compliance checks to be carried out by the Compliance Officer to monitor the investment firm's overall compliance with its regulatory requirements.

Generally, the provided CMPs did not outline, in granular detail, how the necessary compliance tests are being carried out, in line with Rule R.2.35(c) of the Conduct of Business Rulebook. In other instances, the CMP provided had various elements missing, such as: a description of the area to be tested, the relevant procedure explaining how a specific area is going to be tested, and the period of when the testing will be carried out.

It has also been noted that the Compliance Officer would conduct the compliance checks on transactions undertaken in the Prospects Market in the same manner, as if it is the main market and thus no additional checks are made, such as for instance on the disclosure of

added risk, and checks related to the manner in which such products being sold to vulnerable clients.

*Identified Good Practice*

During the follow up meetings, the Authority positively noted that several licensed entities have taken onboard the recommendations put forward by the Authority in respect to the POG area. For instance, the Authority noted that an investment firm has incorporated the actions required by the Authority in relation to the main findings emanating from the two previous supervisory interactions, in the CMP accordingly.

*Identified Bad Practice*

In certain instances, it was noted that CMPs provided did not include the timeframe for the execution of tasks and/or the risk prioritisation of the compliance tasks.

*Expectations*

In view of the peculiarities of the Prospects Market, the Authority expects that the Compliance Function resorts to a risk-based approach in the sampling of client files and ensure that a sample of client files who have invested in Prospects is captured. This workstream should be reflected also within the investment firm's CMP. Licensed entities are obliged to have in place a comprehensive CMP in line with the regulations, rules and guidelines which are issued by the MFSA and ESMA.

Overall, the Authority expects that the CMP tests the adequacy, the implementation and effectiveness of the investment firm's POG policies. It is imperative to note that the CMP should not merely be a tick-box exercise, but rather an on-going live programme aimed at monitoring the overall Company's operations including the POG arrangements as well and the procedures to ensure that all aspects of the business are being adequately monitored. To this end, it is important that the Compliance Officer outlines the frequency of the compliance tasks in the CMP itself. On the other hand, the risk prioritisation is important to ensure that the Compliance Officer focuses on the tasks that pose a higher risk to the investment firm such as for instance: POG arrangements.

***[ii] Compliance Reports including POG Checks***

*Regulatory Requirement*

Reference is made to Rule R.2.35 of the Conduct of Business Rulebook, whereby this rule outlines the compliance obligations related to the review of the POG policies and procedures to ensure the effective implementation of such policies as well as reporting obligations on the distribution strategy of the investment firm.

In line with Guideline G.2.7 of the Conduct of Business Rulebook, the Compliance Officer is expected to assess and evaluate any work, reports or methods adopted by the investment firm's function or personnel in charge of the POG arrangements.

Besides, the ESMA Guidelines on certain aspects of the MiFID II Compliance Function requirements provides further guidance on the reporting obligations of the compliance function. In fact, Guideline 3, paragraph 28 outlines in detail the material information which should be included in a compliance report, namely: general information, manner of monitoring and reviewing, the main findings, actions taken from the review carried out and other compliance matters. Guideline 3, paragraph 29 also provides further guidance on what should be included in the compliance report which covers the POG arrangements area.

*Key Findings*

During its supervisory interactions, the Authority requested a copy of the latest compliance report presented to the Board of Directors and several shortcomings were noted. In this context, the Authority is concerned to note that the compliance reports provided cover generic information and do not go into the specificities of the checks done by the Compliance Officer.

When looking into the POG workstream, the compliance reports presented did not include a summary of the number and type of products being distributed, the target market of the products and whether the products have been distributed outside the target market. In another instance, the Authority noted that the POG compliance checks are being carried out but are not being effectively documented in the compliance report. Overall, the Authority is concerned to note that the internal controls with respect to the POG arrangements are quite weak, which could result in materialisation of the conduct risk with serious consequences on the overall business of the investment firm and ultimately, it's clients.

The Authority also noted that sales outside the negative target market or outside the positive target market were not being included in the compliance report for the respective reporting period.

Moreover, the compliance reports submitted to the Authority normally included a dedicated section related to staff training which was carried out in the respective period. However, it was noted that POG training was not included in the compliance reports provided.

*Identified Good Practice*

The Authority noted that one particular investment firm has included a detailed section on the Product Governance outlining the spot–checks carried out to ensure that the products are being distributed to clients in line with the pre-defined target market assessment. In fact, various important elements were being considered such as: information related to the client, the financial instrument, the distribution strategy, and the risks of both the client and the respective financial instrument being reviewed.

The Compliance Officer provided a summary of the figures carried out whilst considering the distribution strategy, whether there was any deviation from the distribution strategy and the respective clients' risk tolerance and any deviation from the said risk tolerance. Furthermore,

the Compliance Officer gave detailed explanations of the checks carried out outlining what actions were undertaken with respect to any deviations or shortcomings, such as for instance how the main issues which were identified were remediated and communicated internally.

*Identified Bad Practices*

The Authority noted that an investment firm has carried out a sample-based review check of several client files concerning the sale of a recent local bond issue. However, the checks revolved around merely ensuring that the statement of suitability was issued and sent to the respective advisory clients. Other compliance checks were also carried out to ensure that the purchase order form was duly signed. However, the Authority considers that the aforementioned checks are not deemed to be adequate checks on whether the respective client fit the target market identified for the respective financial product made available.

In another instance, the Authority received copies of the checks carried out on the systematic updates of the investment firm's internal system on various financial instruments distributed. Such review was carried out in view of the subsequent changes in the POG policies and procedures. However, the Authority does not deem that such internal system checks are deemed to be effective checks related to POG arrangements, since such checks did not focus on the financial instruments being sold to clients for the reporting period. Furthermore, a sample-based review to check whether such updates had any effect on the client files seems to have been omitted.

Although, the above-mentioned checks are important, the Authority expects that random compliance checks should be carried out on various financial instruments being sold by the Company to ensure that the distribution strategy is consistent with the identified target market.

Another investment firm has notified the Authority that POG checks are being carried out, but these were not effectively documented. In this regard, the Authority is concerned to note that the compliance function is not formally identifying any discrepancies or breaches with respect to the investment firm's POG arrangements.

Similarly, the Compliance Officer of another investment firm explained that the report on the POG checks was kept on file. However, such report was not represented to the Board of the Directors.

*Expectations*

In essence, the Compliance Report being presented to the Board of Directors should specifically include a dedicated POG section which provide an overview of the POG training being provided and a comprehensive summary of the distribution strategy, for that reporting period. Furthermore, the Authority expects that random compliance checks are being carried out by the Compliance Officer to ensure that the distribution strategy is consistent with the identified target market.

It is deemed as best practice that Compliance Officers should prepare the compliance reports, which should contain the information in line with Guideline 3, paragraph 28 of the ESMA Guidelines on certain aspects of the MiFID II Compliance Function requirement.

**WAY FORWARD**

The observations and findings arising from this exercise are being highlighted in this letter with a view to sharing experiences, learning valuable lessons, and identifying good practices for the benefit of the financial market and the retail consumer.

The Board or Executive Committee is to consider which of the risks and observations indicated in this letter are applicable to the firm. To this end, your firm is expected to carry out a gap analysis with respect to the practices and processes of your firm and then to take prompt action to address any identified shortcomings accordingly.

Kindly note that the Authority will be continuously monitoring compliance by investment services licence holders with the applicable regulatory requirements and may engage with particular investment firms on the matters forming the subject of this letter.

Should you require any clarification on the above, please do not hesitate to contact the Authority's Conduct Supervision Function on csuinvestments@mfsa.mt

Yours faithfully,

**Malta Financial Services Authority**

**Christopher P. Buttigieg**
**Chief Supervision Officer**

**Sarah Pulis**
**Head Conduct Supervision**

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