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Additional Information

Level 1 Regulation
Markets in Financial Instruments Directive II (MiFID II) Directive 2014/65/EU- Investor Protection and Intermediaries

Topic
Product governance

Subject Matter
Product governance

Question
How should firms manufacturing financial instruments ensure that costs and charges do not undermine the financial instrument's return expectations, as required by Article 9(12)(b) of the MiFID II Delegated Directive?

ESMA Answer

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Original language

[ESMA35-43-439 Investor protection Product governance Q&A 3]

During the product design phase the firm shall undertake a scenario analysis of their financial instruments[1] and, in this context, simulate product returns taking into account all costs of the instruments (implicit and explicit).

In order to ensure that charges do not undermine the financial instrument's return expectations firms could, for example, assess the consistency between costs and return of a complex product through the Monte Carlo methods. Alternatively, or additionally, firms could, for example, undertake a scenario analysis to assess whether the costs of the product (implicit and explicit) are inferior to the expected return. For instance, where the product qualifies as a PRIIPs, firms should assess whether the costs (implicit and explicit) do not undermine the product's expected return in a “moderate” scenario as referred to in Article 3(3) of the PRIIPs RTS. Firms could also assess whether the expected net return is consistent with those expected for similar products available on the market.

The above list of illustrative examples is not exhaustive and firms could use other methodologies to ensure compliance with Article 9(12)(b) of the MiFID II Delegated Directive. The methodologies adopted to this end should in any case be robust and well documented, with a clear identification of roles and responsibilities in the process.

Finally, manufacturers could calculate the fair value of a product and compare this value with the (expected) price of the product vis-à-vis the end client and assess if the result is consistent with the current practices for similar products available on the market.

Manufacturers should also include the typical taxes end-clients would have to pay (e.g. capital gains taxes) when calculating whether the costs and charges could undermine the financial instruments return expectations.

[1] Article 9(10) of the MiFID II Delegated Directive.