

Brussels, 7 October 2022

EFAMA's REPLY TO ESMA's CONSULTATION PAPER ON THE REVIEW OF THE GUIDELINES ON MiFID II PRODUCT GOVERNANCE REQUIREMENTS

Approach taken

Identification of the potential target market by the manufacturer: categories to be considered

Q1: Do you agree with the suggested clarifications on the identification of the potential target market by the manufacturer (excluding the suggested guidance on the sustainability-related objectives dealt with in Q2)? Please also state the reasons for your answer.

EFAMA welcomes ESMA's objective of ensuring a consistent and harmonized application of the MiFID II product governance requirements, as these are important elements of investor protection; thus, we appreciate the opportunity to provide our views on the different issues included in the ESMA Consultation Paper.

As an initial remark, while we strongly welcome the ultimate goal of the European legislators and supervisors of promoting sustainable development, we wish to express our concerns in relation to the application date of the sustainability-related amendments to MiFID II Delegated Directive by 22 November 2022, given (i) that the final guidelines will not be published until Q1 2023; and (ii) the unclear timing of the Commission's response to the latest and relevant ESAs questions, some of which have implications on what the manufacturers can specify as the sustainability-related objectives their products are compatible with. In order to address these concerns, we would like to ask ESMA to publish guidance to national competent authorities, setting out the expectation that they will not prioritise their supervisory actions in relation to implementation of the MiFID II DA requirements as regards the incorporation of sustainability-related amendments within MiFID product governance requirements until implementation instructions are clarified and finalised. In order to effectively integrate sustainability in the investment decisions of clients, including retail investors, it is key to allow for a flexible approach based on simultaneous learning, the monitoring of the evolution of the regulations already in force and the approval of those yet to be approved, as well as the consolidation of sustainability-related concepts.

On top of the above, we wish to emphasize the importance of the proportionality principle which governs the existing MiFID II rules. Any additional requirements to the product governance regime (such as the request for further documentation, additional explanations about the choices made, consideration of additional factors such as scenario analyses or charging structure), which will impose a greater burden

on manufacturers and distributors, should be explicitly justified by an increase of investor protection need (particularly in relation to non-complex products).

Additionally, please find below some comments on specific paragraphs.

- Par. 13: we would like to receive more clarity on ESMA's expectations regarding this paragraph, as we have some concerns regarding the practicality of its requirements and wish to underline that newly imposed requirements are to be justified if, in their absence, investor protection is weaker. In the case of par.13, if all choices need to be documented, this would lead to a massive increase in the documentation to be kept on record and hold relevant implications for manufacturers; on the other hand, it appears unclear how this would have a beneficial impact on clients.
- Par.14: Further clarification and examples of qualitative considerations that may be used for the potential target market identification by manufacturers, as well as clarity on how manufacturers are expected to sufficiently demonstrate that these qualitative criteria have been taken into account, are needed. We would value, in particular, more guidance on how the outcomes of the scenario and charging structure analyses for a given investment fund should be used in performing the target market assessment for the fund. In addition, it does not seem relevant to ask for qualitative information that cannot be standardized, included in the EMT and then allow comparison between products. We also wish to highlight that significant resources are already being allocated to operationalizing the growing product governance requirements, including data flow between manufacturers and distributors via the FinDatEx European MiFID Template (EMT).
- Par 16: We propose that the language "without merging categories" be removed because it appears disproportionate and overly rigid. There are times when it would be reasonable for the manufacturer to merge the categories, described in par.19, in order to allow the required flexibility when determining the potential target market.
- Par. 19a: Categorizing the clients in accordance with the MiFID categories is more than sensible.
- Par. 19d: Focusing the risk tolerance on the PRIIPs-indicator aligns with our understanding of risk tolerance – degree of risk that an investor is willing to endure given the volatility in the value of the investment. We would appreciate more clarification on ESMA's expectations of risks that could be included, and note that adding additional relevant risks will expand on industry understanding of tolerance beyond volatility (which is already captured by the PRIIPs SRI methodology) and will raise the risk of lower comparability due to the lack of framework, and thus depends on the individual manufacturer's decisions. This could also result in reducing the range of products offered to clients whereas some could match with their own expectations.
- Par. 19e: We are very concerned by the level of requirement and granularity currently proposed under this paragraph, as it appears unclear to us how the "fine tuning" of client's objectives "by specifying particular aspects of the investment and expectations of target clients" should be implemented in practice. Additional clarity on how this "fine tuning" requirement will not lead to an unconscious bias would be beneficial. Furthermore, while we consider it reasonable to extend the objectives beyond solely the investment horizon, there needs to be some harmonisation in the data exchange between manufacturers and distributors.
- Par. 22: We would support this paragraph to refer to the "five categories listed in paragraph 19", rather than "above", for better understanding.

Q2: Do you agree with the suggested approach on the identification of any sustainability-related objectives the product is compatible with? Do you believe that a different approach in the implementation of the new legislative requirements in the area of product governance should be taken? Please also state the reasons for your answer.

We support that the identification of sustainability-related objectives has been aligned with the definition of clients sustainability preferences, as well as this alignment being an option and not an obligation, and highly appreciate the flexible approach to identify any sustainability-related objectives as outlined in par.20, in particular with reference to the provision of the third bullet point (whether, where relevant, the product has a focus on either environmental, social or governance criteria or a combination of them). Flexibility is indeed necessary, as there may be sustainability-related objectives not covered by the sustainability preferences definition (and this may be the case, among others, of certain funds subject to art. 8 SFDR transparency regime). In this regard, we also note that sustainability-related objectives may encompass much more than products only matching the MiFID II sustainability preferences and that, from a product governance standpoint, sustainability-related objectives of a product may also be aligned and linked with the characteristics and objectives of art.8 and art.9 SFDR products.

A point of reservation we have on the proposed guidelines is the reference to E, S and G criteria (or a combination of thereof) which is not required under Art.1 of the Commission Delegated Regulation EU/2021/1253. Consideration should also be given as to how manufacturers may provide relevant details to the distributors regarding framework or methodologies used to categorise investments as sustainable investments.

Importantly, we wish to draw attention to the ongoing uncertainties surrounding how NCAs will actually implement sustainability legislation because it is rapidly evolving and may be subject to changes. For instance, we note the recent Q&As issued by the ESAs to the Commission which could impact the minimum level of commitment to sustainable investments and that the technical screening criteria for the four remaining environmental objectives, which could impact taxonomy alignment, are still to be finalized.

Q3: What are the financial instruments for which the concept of minimum proportion would not be practically applicable? Please also state the reasons for your answer.

While we understand the rationale behind the concept of minimum proportion, we would strongly support a flexible approach as we have concerns about its practical application due to the generally significant lack of reliable data to substantiate a minimum proportion of taxonomy-aligned investments of all relevant financial products and services covered by the guidelines.

We also note that, when advising using portfolio approach and portfolio management, a clients minimum proportion is captured at portfolio level. Per definition, a client that wants a minimum percentage (x%) of sustainable investment, at the same time states that they want a maximum of 100% minus the above-mentioned x% non-sustainable investment. Therefore, unless the minimum percentage expressed by the client is 100%, non-sustainable investment instruments should be distributed as part of a portfolio while not having to rely on diversification or hedging substantiation.

Against this background, whilst the concept of minimum proportion would be practically applicable to funds, below is a non-exhaustive list of instruments for which, in our view, the reference to minimum proportion would *not* be practically applicable:

- (a) Derivatives: it is troublesome that regulation and guidelines broadly cover all derivatives as if they were investments. As they are generally used for hedging purposes, derivatives should be handled methodically separate from investments.
- (b) Shares: Applying the notion of minimal proportion entails analyzing all economic operations of firms whose shares are distributed to determine the proportion of sustainable economic activity for each share. Unfortunately, at this moment, this information is not available for the large majority of shares.
- (c) Sovereign bonds: currently, there is no methodology to assess sovereign bonds against the Taxonomy Technical Screening Criteria.
- (d) Others: corporate bonds and structured deposits.

Further, we would appreciate further guidance on whether the identification of sustainability-related objectives and minimum proportion relates to all financial instruments which are in scope of MiFID II and does not fall within the scope of SFDR.

Identification of the potential target market: differentiation on the basis of the nature of the product manufactured

Q4: Do you agree with the suggested guidance on complexity in relation to the target market assessment and the clustering approach? Please also state the reasons for your answer.

First and foremost, we would like to emphasize the practical value of clustering and how much of a difference it makes whether target markets need to be defined per line or per category (i.e., cluster). Not only does the clustering approach improve operational capacities, but it also reduces the strain on manufacturers and distributors in finding potential target markets while preserving consumer protection.

We agree that more complex products may require a more granular approach. Yet, we strongly support the possibility to cluster products with higher or even the highest degrees of complexity, as long as such products share the same target market categories. For instance, if a smaller portfolio manager may find derivatives (generally) only appropriate for its single ECP, well-informed, risk-seeking client, it should be possible for this manager to define one single target market for all the different derivatives. A possible solution would be to replace the last sentence in par. 27 with the following language: "For certain more complex products, such as certain OTC derivatives and structured products, it is expected that a clustering approach is applied with due care and that firms define the target market with due prudence and granularity". Alternatively, the sentence could be removed entirely. The defining tension should be whether there is a substantial risk that products are included in the target market cluster which they are not compatible, as rightfully indicated by paragraph 30 of the draft guidelines.

The consultation paper currently refers to clustering as an approach to identifying one single (integral) target market for a group of products. We think a perhaps more feasible way to apply clustering is to apply it to a part of the target market definition, referring to an aspect of the product within the cluster and a part of the target market category. For instance:

An asset manager finds CDS (as a cluster), given their complexity, should only be marketed to per se professional investors. Though this part of the target market can be defined with a clustered approach, the other aspects of the target market category would need to be determined (more granularly) based on the specifics of the individual CDS within the cluster.

Those investments which an asset manager classifies as "sustainable investments" under SFDR have a positive target market that consists of investors wishing to invest (a minimum proportion of) their portfolio

in sustainable investments. Again: the other parts of the target market definition of the individual products (being sustainable investments) yet to be determined based on the specifics of the individual product within the cluster “sustainable investments”).

Finally, we note that the addition of sustainability-related objectives to the definition of target markets will likely have an impact on distributors, as earlier defined clusters may be homogenous in risk/ return characteristics, but could differ widely in sustainability-related objectives. Consequently, it could become difficult to apply any clustering at all. In this regard, we would welcome some examples of how to group similar financial products based on their sustainability-related objectives and note that this might be included in Annex IV, which contains examples of good practices.

Timing and relationship of the target market assessment of the distributor with other product governance processes

Q5: Do you agree with the suggested guidance on the assessment of the general consistency of the products and services to be offered to clients, including the distribution strategies used? Please also state the reasons for your answer.

The target market assessment should be made at an early stage by the distributor; before the product is marketed to end clients.

We would support further clarification of the last sentence contained in paragraph 35 in order to avoid confusion between the target market definition and the suitability assessment service: *“The aspects related to this general consistency of products, services and distribution strategies with target clients should be addressed and formalised in the firm’s policy as to the services, activities, products and operations offered or provided”*.

In any event, services provided to clients by the financial entities depend not only on the entity but on the needs and requests of the clients themselves. Considering that, introducing a new obligation of assessment of the consistency of the products and services to be offered to clients, beyond the current practices, seem excessively burdensome and with no clear effects on client’s protection. For example, a product could be defined to be distributed under advised and non-advised service. The fact that during a period only one of those possibilities is demanded by clients should not imply that the distribution strategy should be reconsidered.

Identification of the target market by the distributor: categories to be considered

Q6: Do you agree with the suggested guidance on the identification of the target market by the distributor? Please also state the reasons for your answer.

We agree that manufacturers and distributors should use the same categories. This is paramount, for instance, since those categories are disclosed to the end clients in the PRIIPs KID and using the same methodology is key for the data transfer between manufacturer and distributor. However, as per our response to Q1 in relation to paragraph 16, we propose that the phrase ‘also avoiding merging two or more categories’ be removed.

Regarding the categories that ought to serve as the basis for determining the target market, we observe that paragraph 42 relates to paragraph 19. We believe that this paragraph should also refer to paragraph 20, which adds sustainability-related objectives as part of the client’s objectives and needs to be included in the definition of a target market.

Distribution strategy of the distributor

Q7: Do you agree with the suggested approach on the determination of distribution strategy by the distributor? Please also state the reasons for your answer.

We agree that the distributor should take the distribution strategy identified by the manufacturer into account and review it with a critical look. However, further clarity is needed regarding paragraph 42 in terms of what defining the target market on a more “concrete level” means in practice, as well as how consistently concepts and definitions would function in practice if local nuances exist. Furthermore, we do not agree with the requirement in par. 59 as it requires (through the inclusion of the word ‘should’) the distributors to refine the strategy as identified by the manufacturer taking into account the characteristics of its client base.

Portfolio management, portfolio approach, hedging and diversification

Q8: Do you agree with the suggested approach on the deviation possibility for diversification or hedging purposes when providing investment advice under a portfolio approach or portfolio management? In particular, do you agree that a deviation from the target market categories “type of client” and “knowledge and experience” cannot be justified for diversification or hedging purposes, neither in the context of investment advice under a portfolio approach, nor portfolio management? Please also state the reasons for your answer.

We do not agree with the suggested approach, and believe that deviations from the product's target market under portfolio management agreements are justifiable provided they benefit the consumer.

We would like to highlight, in particular, the universe of tailor-made products with specific cost structures that are not meant for retail investors as a stand-alone product, but rather to be used as building blocks when offering portfolio management. Under such agreement, a professional portfolio manager may acquire and sell financial items on behalf of the client; this means that the portfolio manager may trade financial products that do not meet the client's target market but are nonetheless beneficial to the client (e.g., a broad range of financial instruments used to hedge risks, such as currency risks or interest rate risk; or financial products used for portfolio diversification purposes). Those products or share classes may not charge costs for advice which is charged separately by the distributor. There the target market should be for example “retail clients in combination with portfolio management”. That is already given practice in the EMT. Additionally, a product might be hard to understand on a stand-alone basis and might require additional advice.

In conclusion, the approach proposed in the guidelines risks limiting the portfolio manager's flexibility to the prejudice of clients and prevents them from obtaining an optimal framework for portfolio allocation. That is, considering an investment made in the context of investment advice or portfolio management, either for diversification and/or hedging purposes, it is not relevant which category is outside the positive target market as long as the sale is suitable for the client (particularly, as regards portfolio management, where the adoption of investment decisions corresponds to the portfolio manager and not to the client). Thus, the approach followed by the proposed Guidelines would affect certain clients' portfolios because of their lack of expertise ignoring that (i) such clients are paying for the added value service provided by a professional manager/advisor who effectively has the relevant knowledge/expertise and (ii) the product may be reducing the risk that such clients are facing.

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

Q9: Do you agree with the suggested approach on the requirement to periodically review products, including the clarification of the proportionality principle? Please also state the reasons for your answer.

We agree on the notion of a periodic review and the need for data to be received by the manufacturer from the distributor. We also agree with the proportionality principle embedded in par. 68 by allowing firms to determine the frequency and depth of product reviews taking into account the nature of the product, and where appropriate, the service.

We support the proactive approach by the distributors in the case they have relevant information to support product reviews by manufacturers; as mentioned in paragraph 70, it is important that this approach is proportionate and is limited to information which is of real relevance for producers. We also note that a more proactive approach would place a significant burden for those firms who are identified as distributors under MIFID due to their portfolio management and investment advice activities where typically a large volume of products are distributed, and would therefore appreciate confirmation that it is acceptable for firms to take an exception-based approach.

Finally, we would welcome additional guidance or good practices on how sustainability-related objectives should be covered by periodic review obligations in light of par. 28 of the consultation paper's background section.

Identification of the “negative” target market and sales outside the positive target market

Q10: Do you agree with the suggested approach on the negative target market assessment in relation to a product with sustainability factors? Please also state the reasons for your answer.

We agree that products with sustainability features can still be suitable or neutral for end clients with no sustainability-related objectives. It should not be required to market them as negative to those clients.

However, it is unclear whether firms should identify a negative or positive target market in relation to sustainability-related objectives for products that do not take sustainability factors into account. This is further complicated by the fact that neither legislation nor guidelines define the term “products which consider sustainability factors”. As a result, we would appreciate further guidance (for instance, in Annex IV containing examples of good practices).

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

Q11: Do you agree with the suggested updates on the application of the product governance requirements in wholesale markets? Please also state the reasons for your answer.

Yes, we agree. The target market should always describe the end client and not the intermediation chain.

Annex with good practices

Q12: Do you have any comment on the suggested list of good practices? Please also explain your answer.

We would welcome the inclusion in the list of good practices of examples of products that consider sustainability factors, as well as examples on how to group similar financial products based on their sustainability-related objectives. These examples should also include good practice expectations on distributors regarding understanding framework used by manufacturers to classify an investment as sustainable investment. Finally, we would welcome the inclusion of a case study for complex UCITS.

Case study on options

Q13: Do you have any comment on the suggested case study on options? Please also explain your answer.

With regards to Case study 5, we advise that to be consistent with case studies 1, 2 and 4, the text below Target Market "*the type of clients to whom the product is targeted*" should be removed, as well as the words "given the nature of non-complex UCITS funds".



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