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DSGV-response to ESMA Consultation Paper – Draft guidelines on MiFID II product governance requirements (ESMA/2016/1436)

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The Deutscher Sparkassen- und Giroverband (German Savings Banks Association)[1] welcomes the opportunity to comment on ESMA's consultation paper on draft guidelines for product governance requirements (ESMA/2016/1436).

Q1: Do you agree on the list of categories that manufactures should use as a basis for defining the target market for their products? If not, please explain what changes should be made to the list and why.

The target market criteria proposed by ESMA are basically appropriate as they are derived from the Level 1 and Level 2 product governance requirements. We regard the proposed number of six target market identification criteria in the guidelines as a ceiling. A higher number of criteria would increase the complexity of target market identification to such an extent that this would lead to a significant reduction in the range of products for distributors.

It is generally very positive that the principle of proportionality is explicitly highlighted in the draft guidelines – as it is already in the Level 2 texts. Since the product governance requirements call for close interaction between manufacturers and distributors, each requirement should be checked to determine whether it is proportionate. Particularly the requirement in para. 14 of the draft guidelines that *"(…) each manufacturer should assess the target market at least in each of the six categories.*" does not seem necessary in certain cases. There are, for example, numerous cases (e.g. transactions with professional clients or eligible counterparties, distribution of simple instruments, non-advised and execution-only distribution) where the product governance requirements should be less detailed with regard to the principle of proportionality.

With regard to the individual criteria described in para 16 of the draft guidelines, we want to highlight the following aspects:

- <u>Knowledge and experience:</u>

  The 'knowledge and experience' criterion proposed in the guidelines causes serious problems, as the term 'knowledge and experience' has not been standardised, so that there is no common understanding between manufacturers and distributors. Furthermore, the proposals on knowledge and experience made in the guidelines appear too detailed and therefore unworkable in practice. There should, for example, be no reference to certain time periods

[1] The Deutscher Sparkassen- und Giroverband (German Savings Banks Association, DSGV) is the umbrella organisation of the Sparkassen-Finanzgruppe. The DSGV represents 403 savings banks and seven Landesbanken.

within which experience must be acquired, as implied in paragraph 16 (b). The relevant passages should therefore be deleted.

- Risk tolerance and compatibility of the risk/reward profile of the product with the target market:

  We agree, that the Summary Risk Indicator (SRI) stipulated by the PRIIPs regulation will be relevant for most of the financial instruments. Therefore, it is only consequent, that the SRI plays a key role in identifying the target market. The use of a single risk indicator for packaged and non-packaged products will furthermore increase transparency and therefore foster investor protection.

- Clients' needs:

  The description of clients' needs under 6 (f) seems to be problematic:

  First of all, the product governance requirements relate to products, so that client-specific aspects cannot be taken into account in the process of the target market identification. When identifying the target market, it appears simply impossible to, for example, say anything about clients' age or country of tax residence. These aspects can only be considered by the distributor in the process of investment advice. The relevant passages should therefore be dropped.

  Apart from that, it will be very difficult for distributors to take into account product-related aspects such as 'green investment' or 'ethical investment'. It needs to be borne in mind, that only a very small number of instruments will be characterised as green or ethical investment products. With regard to the principle of proportionality, distributors should only be obliged to take into account the product related aspect, if the investor requests a product with a special feature. A general obligation to match such rather rare product characteristics would be disproportionate. The special nature of the criterion should be reflected in the guidelines.

Q2: Do you agree with the approach proposed in paragraphs 18-20 of the draft guidelines on how to take the products' nature into account? If not, please explain what changes should be made and why.

The draft guidelines assume – correctly and in line with the Level 1 and Level 2 requirements – that, with regard to the principle of proportionality, the granularity of target market identification should be geared to the complexity of products. Yet the draft guidelines fail to draw the logical conclusion that certain simple products are suitable for the mass retail market and a detailed target market identification is unnecessary in their case. This is stated in both ESMA's Final Report (p. 53,

paragraph 11) and in the Delegated Directive (EC 18) as well as in the consultation paper (page 7, paragraph 17). It should be included by way of clarification in the guidelines as well. Furthermore, it should be clarified, that the products concerned include shares and simple bonds.

The clarification that for tailor-made products no abstract target market identification by the manufacturer is required (paragraph 20) is positive, as the products concerned are tailored to each client. The individual client is therefore the target market. The requirement to define an abstract target market only applies to products that are distributed more widely.

Q3: Do you agree with the proposed method for the identification of the target market by the distributor?

We regard the content of paragraphs 23 ff. as highly problematic overall. According to it, irrespective of whether or not a target market has been identified by the manufacturer, the distributor would at the same time always be required to identify a target market of its own as well. This blanket obligation would go beyond Level 1 and Level 2 and thus establish an additional requirement for distributors.

As the wording of Article 24 (2), second subparagraph of MiFID II shows, distributors have to "take account of" the target market identified by the manufacturer when selling products. It does not stipulate a requirement for the distributor to always identify a target market of its own or to concretise the target market identified by the manufacturer. In our view, no extension of the requirements imposed on distributors was intended at Level 2. This follows from a written response by the European Commission on 13 May 2016 to a question by MEP Ferber, the ECON rapporteur on MiFID II:

> *"Unlike manufacturers who need to establish and publicly communicate the relevant target markets they have identified, distributors need to be mindful of the relevant target market when assessing whether a particular product is aligned to an individual client`s financial needs – this obligation arises by virtue of Art. 24 (4), second subparagraph, and Art. 9 (3) (b) of Directive 2014/65/EU."*

For practitioners, it is vital that this common understanding of the European Parliament and Commission is also reflected in the guidelines. Otherwise the Level 3 requirements would contradict those set at Level 1 and Level 2. A requirement for distributors to always identify a target market of their own would lead to serious restrictions on the range of products available to investors.

The entire remarks in the consultation paper on target market identification by distributors should therefore be confined to the special case in which no target market has been identified by the manufacturer.

If ESMA should not follow, we suggest at least to clarify, that for concepts for the definition of the target market, that have been developed by manufacturers and distributors, a second target market definition is not required, since the common target market definition meets the requirements for manufacturers and distributors.

Q4: Do you agree with the suggested approach on hedging and portfolio diversification aspects? If not, please explain what changes should be made and why.

1. Portfolio advice

A positive point is that ESMA acknowledges in paragraph 29 ff. on page 9 f. that the abstractly identified target market need not always be the deciding factor when it comes to concrete distribution of a product. ESMA presents this point very graphically in paragraph 31, using portfolio advice as an example. It is obvious that a risky product does not in itself suit a more conservative-minded investor, so that when separately matching target market and client this would be a case of distribution outside the target market. When the portfolio structure is taken into account, however, the product is nevertheless shown to be suitable, as mixing individual riskier instruments into the highly conservative portfolio is precisely in line with the investment objectives the client had in mind. The guidelines confirm this assessment.

What we do not understand, however, is why the guidelines nevertheless create the impression that the product has to be seen separately for the purpose of identifying the target market. This is particularly puzzling, as the example given in the consultation paper makes clear that such an isolated approach ignoring the portfolio structure would be pure formalism and produce incorrect results. It should also be borne in mind in this context that such incorrect results produced by the target market assessment may be reported to the issuer and can lead there to faulty product monitoring. In the above example, distribution outside the target market under the guidelines would be reported to the issuer, which, together with other reports, may lead to the issuer modifying the target market although the error reported is merely due to the fact that the portfolio effect was not taken into account. For this reason as well, it should be made clear that the target market definition is taken into account in portfolio advice on putting together the portfolio but should be omitted where individual instruments are distributed. Only this approach does justice to the special nature of portfolio advice.

If these arguments are not acknowledged and the obligation to assess the target market is retained, it should at least be made clear that no deviations from the target market should be reported to manufacturers within the scope of portfolio advice. There are likely to be a large number of deviations in practice that are all due to the above-mentioned portfolio effect. Communicating such deviations to the manufacturer would deliver no added value or could even lead to faulty product monitoring by the manufacturer. Portfolio advice should thus be explicitly excluded.

2. Portfolio management

With regard to portfolio management, it is the manager`s responsibility to ensure the compatibility of the portfolio with the target market. The introduction of the requirement, that each product has to be compatible with the target market would ignore the benefits of diversification and contradict the idea of portfolio management. Therefore, we disagree with the idea, that for every product subject to the portfolio management the target market shall be assessed, as it is foreseen in para. 43 of the draft guidelines.

In this regard, we want to highlight, that MiFID II contains several additional requirements that are meant to increase the protection of the investor (such as the ban of inducements for portfolio managers). Furthermore, the investor specifies detailed investment guidelines, in which the portfolio manager may operate. On this account there is no need to assess the target market for each product subject to portfolio management.

Q5: Do you believe further guidance is needed on how distributors should apply product governance requirements for products manufactured by entities falling outside the scope of MiFID II?

1. Suitability for the mass retail market

With regard to the reference in paragraph 41, it should be made clear that classification of products as suitable for the mass retail market should be possible not only for execution-only but, in general, for all distribution channels. The problem that there will be no manufacturer target market for shares and corporate bonds in most cases does not differ between the individual distribution channels.

Aware of this problem, the Level 2 legislator created the possibility to gear simple products, e.g. shares and simple corporate bonds whose manufacturers are not required to identify a target market, to the mass retail market. This is the only way a significant reduction in the product assortment can be avoided, particularly as paragraph 54 says that distributors are not allowed to

sell a product for which there is no manufacturer target market and for which they cannot identify a target market themselves. This tough consequence can only be accepted if it is made easier for distributors to identify a target market for simple products. Otherwise the consequence outlined in paragraph 54 would lead to a significant reduction in the range of funding products on offer to companies. This would be seriously at odds with the other political objectives of the EU (e.g. Capital Markets Union).

2. Time scope

Furthermore, we disagree with the draft guideline under paragraph 56 where it states that products which have been manufactured before 3 January 2018 but which are distributed to investors after that date should fall within the scope of product governance requirements applicable to distributors, in particular, the requirement to identify a target market for any financial product.

Distributors should be given the same treatment as manufacturers. While manufacturers that produced products before 3 January are exempted (paragraph 55) from identifying the target market (until the review process cycle is applied), distributors would be obliged to define by 3 January 2018 the target markets of all products which are still being distributed but produced before the implementation date. This creates a disproportionate burden on distributors which will have to go through the process of data gathering and defining the target market by 3 January 2018.

We do not support this difference of treatment. It is positive, that ESMA acknowledges the problem and proposes an obligation to define target markets in the next product review cycle. This is in line with the position EBA took in the Product Oversight, where EBA clearly states that only new or changed products will be subject to the Product oversight requirements.[2] If ESMA considers it disproportionate for manufacturers to define a target market for their own products manufactured before 3 January 2018, it will be completely impossible for a distributor to define target markets for all the products coming from different manufacturers that it distributes. ESMA should treat this issue as a legacy one and should not treat differently entities that face the same issue as this would lead to a distribution stop for thousands of products. We therefore suggest that distributors benefit from the same application of product governance requirements for legacy products that manufacturers benefit from. It should be made clear, that existing products can be sold without a target market being defined until the end of the manufacturer's first product review cycle.

[2] EBA Final Report, 15 July 2015, EBA/GL/2015/18, S. 6: "*The EBA stipulates that as of the implementation date, these Guidelines apply to all products brought to the market after the implementation date, as well as to all existing products on the market that are significantly changed after that.*"

Q6: Do you agree with the proposed approach for the identification of the 'negative' target market?

From our point of view, the concept of the negative target market goes beyond the MiFID II level 1 and level 2 requirements where it is only required to define the positive target market, and – as part of this process – the groups shall be identified, for whose needs, characteristics and objectives the financial instrument is not compatible. The latter requirement can be derived from the positive target market, which is generally acknowledged by ESMA in para. 59 of the draft guidelines. The concept proposed by ESMA would have the consequence that three target markets have to be defined: The positive target market, the negative target market and a grey target market, that is neither the positive nor the negative target market. This obligation that is not foreseen on Level 1 or 2, would further impede the target market identification. Defining a negative target market would furthermore lead to a de facto distribution ban, that would be disproportionate and is not foreseen by MiFID II's requirements.

This does not contradict the fact that the distributor should always check the suitability of the product in advised situations when selling outside the target market or even in a 'negative' target market. In this last case, if the suitability is verified the distribution must be allowed. This is in line with the general concept of product governance where the distributors should take into account the target market for the distribution of products. This understanding is further supported by the fact that distributors are required to report sales outside the target market, which clearly demonstrates that they are allowed.

Apart from that, paragraph 63 creates the impression that the sale of products outside the target market is only possible in rare cases. This approach would lead to a de facto ban on distribution. This would be completely unreasonable and go beyond the requirements set at Level 1 and Level 2. It already follows from the fact that sales outside the target market have to be reported to issuers that these generally need to be permissible. This fundamental assessment by the legislator should not be modified via the guidelines.

Q7: Do you agree with this treatment of professional clients and eligible counterparties in the wholesale market?

Paragraphs 66 ff. contain some very important clarification on the treatment of the target market where products are distributed to wholesale clients:

- Of particular importance is the clarification in paragraphs 66-69 to the effect that the target market is irrelevant where products are sold to professional clients or eligible counterparties if

these only buy the product to sell it on to end-clients. From the issuer's perspective, this case is to be treated as if the product were sold directly to end-clients. For these, the target market naturally needs to be identified. What should be dropped is the reference in paragraph 69 to the fact that the eligible counterparty that buys the product to sell it on as a distributor should be required to reassess the target market in line with its product governance obligations as a distributor. As explained earlier, this is not envisaged at Level 1 and Level 2.

- As regards distribution to eligible counterparties as end-clients (paragraphs 75, 76), it is correctly pointed out that Article 30 (1) of MiFID II suspends the obligations for distributors under Article 24 (2) of MiFID II. Even though Article 30 (1) of MiFID II explicitly refers only to the obligations for distributors under Article 24 of MiFID II, the assessment made in Article 30 (1) of MiFID II should be taken into account also with regard to the requirement to identify a target market under Article 16 (3) of MiFID II. It should, in particular, be borne in mind that identifying a target market that does not have to be taken into account for distribution purposes appears to be a case of pure bureaucracy. It should hence be made clear in the final guidelines that no target market identification is needed for products that are to be sold exclusively to eligible counterparties as end-clients. This would only be logical in view of the provision of Article 30 (1) of MiFID II.

- In the passages on distribution to professional clients as end-clients there is, in our view, a contradiction between the rules on product governance and the rules on cost transparency. Whereas reduced requirements can be agreed for cost transparency under Article 50 (1) of the MiFID II Delegated Regulation, the guidelines do not allow such reduced requirements in regard to product governance. This is inappropriate in our view. Apart from that, the distinction between per se professional clients and elective professional clients in paragraph 72 of the draft guidelines is inaccurate and the relevant passages should be deleted. In line with section II.1 of Annex II to MiFID II, the criteria and procedures mentioned therein have to be fulfilled for a client to be classified as an elective professional client. Once this classification has been carried out, clients are 'professional clients'.

Q8: Do you have any further comment or input on the draft guidelines?

1. Assessment solely of knowledge and experience in non-advised business

It should be made clear that in non-advised business solely the 'knowledge and experience' criterion has to be assessed. We believe that it would be incompatible with MiFID II if a distributor were to be required in non-advised business to also take into account client information that it has obtained outside non-advised business, e.g. in the course of investment advice or lending. In our

view, footnote 8 on paragraph 36 (page 11) could be misunderstood and should therefore be deleted.

The distinction between advised business and non-advised business should, moreover, not be softened via the 'actively market' criterion, as implied in guideline 43. Even if distributors take measures to promote the sale of a product, this does not alter the fact that only limited client information and data are available to them in non-advised business and that they can thus only assess knowledge and experience. This limited scope for assessment, to which ESMA draws attention at various points in the draft guidelines, also applies where products are actively marketed. Insofar as 'actively market' refers to the cost transparency requirements under Article 50 (6) of the MiFID II Implementing Regulation, adoption of the assessment therein is inappropriate. Whilst cost transparency is about displaying the product-related costs, which is mandatory for the distributor in the case of actively marketed products, the problem with target market identification is the missing client information and data. The fact that certain sales or placement agreements exist, thus establishing proximity to the manufacturer, may enable the distributor to determine and display the costs inherent in the product. The fact that client information and data are not available is not altered in any way by product-related sales measures. As a result, the statutory distinction between advised orders and non-advised orders and the accompanying obligations should be retained also for target market identification.

2. No restriction of the product assortment in non-advised business

The wording in paragraph 36 reading "*they should pay particular attention to situations where they might not be able to make a thorough target market assessment by virtue of the type of services they provide*" is unclear. Identification of the target market is not impaired by the type of service via which a product can be purchased. If the intention here is to establish that no suitability test is performed where services are provided outside investment advice, then this is already specified by a legislator's assessment. Matching the client against the target market is thus still possible, namely to the extent provided for under Article 25 (2), (3) and (4) of MiFID II.

We therefore see a clear conflict with Level 1 if the guidelines were to be understood to mean that the distribution of certain products is only to be possible in future within the scope of investment advice. Such an understanding would run counter to the present system of non-advised business and execution-only business under MiFID II. It is precisely in line with what the legislator basically decided, i.e. that distribution of non-advised products should be possible subject to an appropriateness test for each product and that features such as, for example, the investment objective should not play any role. These decisions by the legislator must be respected when

designing the product governance regime and must on no account be circumvented via Level 3 measures.

A different approach could effectively lead to the abolishment of non-advised business for a large number of products, though Level 1 does not deliver any legal basis whatsoever for this. What is more, this would not be in the interest of investors, as many investors have deliberately opted for the non-advised distribution channel for securities, as they can and wish to make their investment decisions on their own at a time of their own choosing. This would no longer be possible in future if it were to be concluded that the range of non-advised products would be seriously restricted.

3. Distributors' feedback to manufacturers

ESMA correctly points out in paragraph 48 ff. of the draft guidelines that product governance should include a dialogue between manufacturers and distributors. As in non-advised business a distributor will potentially offer virtually all products available on the market for sale, the flow of information is highly complex, since all relevant information on all products must be available to all distributors. This requirement shows that the amount of information in each case has to be limited so that implementation remains manageable. Any information overload threatens to make the exchange of information too complex to handle in practice. Therefore, it should be made clear in the guidelines that manufacturers only have to make available the information and data of relevance for the distribution processes. Furthermore, it should be clarified, that not all sales outside the target market have to be reported to the respective manufacturer but that this may be made dependent on certain absolute and relative thresholds being reached. This is the only way to ensure that irrelevant information is not exchanged and that distributors' feedback is confined to information that gives grounds for reviewing the target market.

4. Case studies

As ESMA has, for correct reasons, not proposed any rigid target market concept but is merely drafting the framework for target market identification, the concrete examples of application of the guidelines in Annex IV should be dropped. The definitions there are highly detailed in some cases, so that it is unclear whether the examples are actually implementable when it comes to the sale of third-party products. This applies particularly in view of the fact that we are not aware of any comparable concepts from other European countries. This would also be consistent with the legislator's decision to issue the product governance requirements by way of a directive.