Securities and Markets Stakeholder Group

26 October 2022
ESMA22-106-4247

ADVICE TO ESMA

SMSG advice in respect of the ESMA Consultation Paper on the Review of the Guidelines on MiFID II product governance requirements

I. Executive summary

1. In general, the SMSG is of the opinion that the revised guidelines are balanced, fairly reflect and elaborate on the changes in Level 1 and Level 2 texts, and adequately deal with the results of the 2021 Common Supervisory Action on MiFID II Product Governance Requirements. The SMSG highly appreciates the continuation between different ESMA work streams, in the sense that the draft guidelines are heavily informed by ESMA's Common Supervisory Action.

2. The SMSG stresses the need for consistency in terminology and processes (i) between the product governance guidelines and industry standards (such as the European MiFID Template and the Association concept) that are generally used in the market; (ii) between manufacturers and distributors; (iii) between the product governance guidelines on the one hand and the suit-ability and appropriateness guidelines on the other hand; and (iv) between the product governance guidelines and the PRIIPs framework (where relevant). The SMSG therefore advises ESMA to stimulate the further development of market standards, to align the wording of its guidelines with industry standards, and to ensure that the product governance and suitability guidelines come into effect at the same moment.

3. The SMSG agrees that the target market should be sufficiently granular, but not overly granular. If target markets are defined in too much detail this may put the continued existence of an open architecture at risk, it would favour the largest players, and it would make an efficient feedback loop between distributor and manufacturer more difficult. Therefore, a balance needs to be struck also between granularity of target market requirements on the one hand and practicability, efficiency and open architecture on the other hand.

4. The product governance requirements may currently overly reduce the product offer for investors, for three reasons: (i) distributors do not have sufficient client information to assess whether the client fits the target market; (ii) distributors are not willing or able to define a target market, because they have insufficient resources or information; (iii) manufacturers / distributors define the target market at the safe (narrow) side, while distributors do not sell outside the target market, especially not for non-advised retail clients (even if theoretically possible after motivation / documentation). The SMSG proposes several changes to the guidelines to deal with those problems.

5. The SMSG advises ESMA to clarify the legal effect of mentioning a certain practice as a "good" or a "bad" practice, and of using case studies in the guidelines.

6. After the guidelines will have been finalised, the market will need time to adapt. ESMA should take this into account when determining when the guidelines will enter into force.

II. General remarks

7. In general, the SMSG is of the opinion that the revised guidelines are balanced, fairly reflect and elaborate on the changes in Level 1 and Level 2 texts, and adequately deal with the results of the 2021 Common Supervisory Action on MiFID II Product Governance Requirements. The SMSG indeed highly appreciates the continuation between different ESMA work streams, in the sense that the draft guidelines are heavily informed by ESMA's Common Supervisory Action.

8. The SMSG stresses the need for a proportional application of the product governance requirements. This is already reflected in certain specific guidelines, such as para 27, which requires that in ensuring that homogenous clusters are identified, firms should pay particular attention to the level of complexity of products.

9. The SMSG stresses the need for consistency in terminology[1] and processes (i) between the product governance guidelines and industry standards (such as the European MiFID Template and the Association concept) that are generally used in the market; (ii) between manufacturers and distributors; (iii) between the product governance guidelines on the one hand and the suitability and appropriateness guidelines on the other hand; and (iv) between the product governance guidelines and the PRIIPs framework (where relevant). ESMA should ensure consistency in and between its own guidelines, as well as between the terminology and processes of the PRIIPs framework and the product governance framework, so as to avoid confusion and duplication of work. Moreover, ESMA could stimulate industry associations to further develop market standards in the light of the revised product governance, suitability and appropriateness guidelines.

10. In this regard, the SMSG remarks that the draft guidelines deviate on several occasions from the terminology used in the European MiFID Template (EMT) and the association concept, which have become industry standards. The SMSG strongly advises ESMA to align the wording of the guidelines with these industry standards, unless ESMA has good reasons to use a different wording. The SMSG has debated on the question whether ESMA should go beyond that and endorse the industry standards. The SMSG does not think that ESMA should do so. It should, however, in the guidelines clearly refer to current industry standards, and clarify that it aligns the wording the of the guidelines with the industry standards as much as possible.

11. In view of the close connection between product governance and suitability, the two sets of guidelines should be optimally aligned. Therefore, the SMSG is of the opinion that the two sets of guidelines should be finalised and come into effect at the same moment.

12. The SMSG agrees that the target market should be sufficiently granular, but not overly granular. If target markets are defined in too much detail this may lead to "closed shops", where only distributors from the same group as the manufacturer are able to fully comprehend the scope and meaning of overly granularly formulated target markets. Requiring too much granularity may put the continued existence of an open architecture at risk, which would be detrimental for investors. Moreover, overly complex requirements would favour the largest players. Therefore, a balance needs to be struck also between granularity of target market requirements and practicability in terms of compliance.

    For instance, the case study at p. 50 of the draft guidelines mentions under "clients' knowledge and experience" "experience with direct investment in structured products"; the case study at p. 51 mentions under "clients' knowledge and experience", "some knowledge or experience of the share index and the index mechanics". However, with this level of detail of target market descriptions, the "knowledge and experience" section would include at least 10 to 15 categories. In integrated financial groups, a distributor will easily implement such target market descriptions; for independent distributors this will be much

[1] Cf. for instance the study by FinaMetrica, "Moving towards a consistent risk language" (October 2016).

harder to match with information gathered from clients in the context of suitability and appropriateness assessments that are not aligned with such overly detailed target market descriptions.

In the same vein, the “know your distributor”-requirements for product manufacturers should not be overly demanding, since this could negatively affect the development of open architecture models and hamper the offering of independent advice.

13. Moreover, for an efficient feedback loop to be installed between product distributor and product manufacturer, categories which are less granular would need to be introduced. The SMSG is of the opinion that there is a trade-off between on the one hand the granularity and relevance of the information in the target market, and on the other hand the feasibility of an efficient feedback loop.

14. A closely connected, but different issue, is that the product governance requirements should not overly restrict access of investors to higher risk products or to products requiring higher knowledge and experience, provided the appropriate investor categories are duly targeted for the appropriate products.

15. The SMSG has a methodological comment in respect of the establishment of “good” and “bad” practices in the guidelines. While the SMSG is of the opinion that, in general they may be of help in [2]clarifying the meaning of the regulatory framework, it strongly advises ESMA to clarify what is the legal effect of mentioning a certain practice as a “good” or a “bad” practice. Are those examples meant to clarify the guidelines, or even to nudge market participants to behave in a certain way (good practices)? Are the “bad” practices prohibited in all circumstances? Are they subject to sanctions?

16. Similarly, the SMSG wonders what is the legal effect of using case studies in the guidelines. For instance, the case studies use a certain vocabulary. Should market participants use the same, as a kind of template?

17. After the guidelines will have been finalised, the market will need time to adapt. ESMA should take this into account when determining when the guidelines will enter into force. The SMSG advises ESMA to urge the NCAs to take into account practical constraints of market participants in complying with these guidelines. A distinction should be made between what is theoretically possible and what is for the time possible from a practical point of view, for instance due to the lack of data.

III. Comments on the individual guidelines

3.1 General

18. Para 13: The proposed new guideline requires that, “in general, firms acting as manufacturers and/or distributors should substantiate and document choices made in the context of their product governance arrangements.” The SMSG advises ESMA to clarify what it means with “substantiate and document”. How should this be done? How much and what type of information should substantiate the choices made? Para 20 of the background information (p. 8) states in this respect that this should deal with, for instance, the choices made in determining the compatible distribution strategy for the product and the way in which the firm will monitor whether a product is reaching the intended target market. It is not clear whether and to what extent the guideline requires substantiation and documentation beyond those aspects; nor how far such “monitoring” should go.

3.2 Guidelines for manufacturers

19. Para 14: The proposed new guideline states that “in identifying the target market for a product, manufacturers should also take into account the results of the scenario and charging structure analyses undertaken for the relevant product”. The SMSG advises ESMA to clarify what is meant with “scenario

analyses", taking into account the following: for PRIIPs there is already a PRIIPs scenario analysis, and there should be no need for a separate target market scenario analysis for purposes of product governance; for non PRIIPs (shares, bonds, …) it should be clarified how such a scenario analysis should take place. The SMSG furthermore advises ESMA to also clarify what is meant exactly with "charging structure". Again for PRIIPs products, the PRIIPs process should suffice. The SMSG advises ESMA to explicitly clarify this.

20. Para 19.d: The guideline refers to basic risk attitudes, and gives certain examples. However, the examples are not aligned with the wording of industry standards. As mentioned above, the SMSG deems it important that the wording of the guidelines only deviates from the industry standards if there are good reasons for doing so, which should then be clearly explained.

21. Para 19 d: One of the terms used as an example in the guidelines is "conservative". However, the SMSG is of the opinion that this term is not clear and may even be misleading; "risk-averse" expresses more directly what is actually meant, and is a term which the average investor will therefore understand better.

22. Para 19 d: The SMSG has debated on the question whether in the context of the *risk/reward profile of the product* the basic risk attitudes of investors should be standardised. There is already a high level of standardisation in terms of the industry standards. The SMSG believes that at least 5 risk categories are needed in order to have sufficiently meaningful distinctions between different *types of investors* (this is to be further discussed in a suitability test context).[2] Moreover, it is of the utmost importance that the basic risk attitudes of investors used in the target market description of product manufacturers are easily translated into investor risk profiles by the distributor under the suitability test.

23. Para 19.d: In respect of the categories to be considered, ESMA proposes several clarifications. With regard to risk tolerance and compatibility of the risk/reward profile of the product with the target market, the draft guidelines provide that firms should use the risk indicator stipulated by the PRIIPs Regulation or the UCTIS Directive, where applicable, to fulfil this requirement, but that, if needed, firms should additionally take into account relevant risks that may not be measured by the risk indicator. As an example, the draft guidelines refer to the impact of currency risk on the target market for PRIIPs to be issued in a currency that is different from the reference currency of that market (para 19 d). However, this is only relevant if the product is only offered in one market. If the product is offered on different markets, currency risk will be different for investors trading in different currencies. If product manufacturers would need to take this into account, they would have to produce different target market descriptions for potential target markets in MS with different currencies. The SMSG is of the view that this would go too far, and that this example is not adequate for the target market requirements for product manufacturers. Warning against possible currency risk should rather be the responsibility of the product distributor, who could include this in the description of the actual target market, if relevant. The product manufacturer might refer to a "reference currency" in terms of historic volatility of the product.

    ESMA should consider making a non-exhaustive list of possible risks that are not included in the PRIIPs / UCITS risk indicators and that product manufacturers (and distributors) should consider when defining the target market category of "risk tolerance and compatibility of the risk/reward profile of the product with the target market". For the reasons mentioned above, the SMSG is of the opinion that "currency risk" is not a good example in this regard. One example may be liquidity risk. The SMSG advises ESMA to provide further examples in the guidelines.

24. Para 19 e: The SMSG deems it important that the wording of the guidelines do not deviate from the current industry standards, unless this is explicitly intended by ESMA. Guideline 19 e. makes reference to the "expected investment horizon" of the product, whereas the industry standards refers to the "minimum investment horizon".

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[2] Cf. for instance the study by FinaMetrica, "Moving towards a consistent risk language" (October 2016).

25. Para 20: ESMA requests input on whether there are categories of financial products for which the reference to minimum proportions would not be possible. This is a very relevant question, but the SMSG doubts whether it should be addressed in the context of MIFID product governance guidelines.

    Nevertheless, the SMSG deems it important to provide input to ESMA on this question. The SMSG supports ESMA's approach to handle the concept of "minimum proportion" with some flexibility. The SMSG fully shares ESMA´s analysis that the concept of "minimum proportion" does not apply to financial instruments for which it is not practically possible to define such minimum proportion and that, instead, these types of products could refer to the actual proportion instead of the minimum. The SMSG is of the opinion that a distinction should be made between what is theoretically impossible and what is for the time being impossible from a practical point of view. In particular, the SMSG points at the following problem areas.

    (i) Shares / Bonds / Structured securities. These financial instruments are not in the scope of the SFDR. Therefore, any "minimum proportion" requirement for financial products deriving from the templates set out in the Annexes to Delegated Regulation (EU) 2022/1288 does not apply to those financial instruments which do not qualify as financial products under the SFDR regime. The SMSGs sees no legal basis for extending this requirement to these financial instruments within the context of the MiFID II product governance framework. E.g., most structured securities are – different from an investment fund – not actively managed during their life cycle. For these financial instruments, it is hardly possible for an issuer to give any commitment on keeping a minimum proportion from issuance to maturity. Hence, the information on the actual proportion at the moment of issuance should be sufficient.

    (ii) Private equity funds / infrastructure funds play a pivotal role in the transformation towards a more sustainable economy. However, they often have a fund of fund structure. Hence, "minimum proportions" can only be defined if each of the underlying funds is able to define minimum proportions, which is for the time being, rarely the case. As a result, private equity / infrastructure funds may well refrain from claiming a minimum proportion of sustainable assets, even if they have ("green-bleaching").

    (iii) RMBS. Given the fact that banks will in the next few years need to report on their climate risk, one can imagine that credits for energy-inefficient residential mortgage will be increasingly securitized. For this reason, it would be fair that the investor knows to what extent the underlying loans are for energy-inefficient / -efficient mortgages and have a higher/lower climate risk. This requires data. Moreover, neither the Taxonomy Regulation nor the Sustainable Finance Disclosure Regulation at present incorporate criteria to judge the sustainability of residential real estate, making it not only practically (data) but also theoretically impossible to judge the degree of sustainability of RMBS.

    (iv) Social bonds/sustainable bonds. There are certain market definitions (for instance by ICMA), but the legislative definition of social bonds / sustainable bonds may be tricky, so that it is difficult to define what the minimum proportion should be. Moreover, it would be even more difficult to agree on minimum proportion on a global level.

26. Para 20: The guideline states that "firms <u>may</u> specify, where relevant, the following aspect (in line with the definition of sustainability preferences …)." The SMSG has discussed the question whether it would not be better for ESMA to replace "*may*" with "*should*" or with "*should, in principle, if possible and relevant*". The SMSG sees a number of drawbacks in replacing "may" with "should", such as the fact that, due to data scarcity, it will not always be possible to provide those specifications, whereas for certain products, it will not even be relevant to do so. Moreover, if it would be an obligation for firms to specify those aspects, that would create difficulties in the feedback process on those aspects (firms should then have processes allowing them to give feedback on all those aspects), that are at present difficult to overcome.

27. Para 20, bullet 4: This guideline should clarify what is meant with "where relevant".

28. Para 20, bullet 4: The guideline states that "Firms *could* use the categories presented in the SFDR RTS (instead of an approach based on each PAI indicator)…". The SMSG is of the opinion that firms *should* use one or the other, and therefore advises to change this sentence as follows: "Firms should use the categories presented in the SFDR RTS and/or an approach based on each PAI indicator".

    As to the question whether a manufacturer should specify sustainability-related objectives of a product by referring to the sustainability data of either the issuer of the product, or the product itself (para. 27 of the "Background" of the consultation paper), there is no one size fits all-approach. In certain cases, it should even be possible to combine both concepts. For example, the manufacturer of a structured security that is issued as a bond and has a basket of shares as underlying (derivative component) could specify the sustainability-related objectives of that product by making reference to both the bond and the derivative component. The sustainable characteristic of the bond component could for instance derive from the issuer´s use-of-proceeds whereas the sustainable characteristic of the derivative component is stemming from the demand impact which is caused by the issuer´s risk reducing hedging practice through a derivative. As this question ties in with the treatment of derivatives from a sustainability perspective, the SMSG would like to take this opportunity to stress the importance of further considering the role of derivatives in furthering taxonomy-aligned activities. It would indeed be of importance that the ratios appropriately reflect the contribution of derivatives to taxonomy-aligned economic activities. Work should be encouraged on clear methodologies in order to assess derivatives´ alignment.

29. Para 24: The SMSG advises ESMA to make a number of textual changes to clarify the text and avoid vague statements. The current paragraph reads as follows: "*In this context, manufacturers should define and adequately graduate the level of complexity to be attributed to manufactured products to determine the necessary level of detail with which the target market should be identified. Although complexity is a relative term, which depends on several factors, firms should also take into account, the criteria and principles identified in Article 25(4) of MiFID II.*" The SMSG advises to change this paragraph as follows: "*In this context manufactures should determine the level of complexity of manufactured products, amongst other things by taking into account the criteria and principles identified in article 25 (4) MiFID II. The level of complexity of the product will help the manufacturer in determining the adequate level of detail of the target market description.*"

    Moreover, the SMSG is of the opinion that, even though it is not up to supervisors to determine the level of complexity of products, more guidance is needed on what elements firms should consider to determine the level of complexity of products.

30. Para 26: This paragraph states that in regard of certain particularly complex and risky products, a very careful target market assessment is required, resulting in the identification of a very narrow target market "*or no compatible target market at all*". The SMSG agrees that certain products should not enter the market. However, to that end product manufacturers should have procedures in place in the product design phase to avoid the creation of products for which no compatible target market would exist. The SMSG advises ESMA to reflect this in the guidelines, rather than suggesting that such products would be designed, after which "no compatible target market" would be assigned to them.

31. Para 27: The SMSG advises to change the following sentence: "In ensuring that homogenous clusters are identified, firms should pay particular attention to the level of complexity of products, meaning that also for more complex products the cluster should be homogenous and therefore the clusters may need to be more granular."

3.3 Guidelines for distributors

32. Para 34: This paragraph states that the actual target market identification by the product distributor should occur at an early stage, when the firm's business policies and distribution strategies are defined by the management body …". The SMSG is of the opinion that the actual target market definition of individual products is not the task of the management body, and cannot take place at the same time as

the determination by the management body of the firm's business policies and distribution strategies. The management body should indeed define the firm's business policies and strategies, and in doing so can also identify the *features of its clients base*. On that basis the management body can identify the *type of products* and the *range of potential target markets* that could match some of its clients and can be considered to include in the product range of the firm. The actual choice of which concrete products to include in the product offer and the determination of the actual target market for each individual product, will, however, be determined thereafter on the basis of these general guidelines.

33. Para 39: The SMSG advises to replace the term "behavioural finance", which is a science domain, by the term "nudging", which more accurately indicates what the goal of those practices is.

34. Para 42: This paragraph gives the following example "*regarding the manufacturer's target market category of knowledge and experience, which may broadly refer to "basic", "average" or "advanced" investors, the distributor should adopt a more granular classification consistent with its suitability or appropriateness arrangements, where appropriate given the features of the products*." The SMSG agrees that the target market should be sufficiently granular, but not overly granular. If target markets are defined in too much detail this may lead to "closed shops", where only distributors from the same group as the manufacturer are able to fully comprehend the scope and meaning of overly granularly formulated target markets. Requiring too much granularity may put the continued existence of an open architecture at risk, which would be detrimental for investors. Moreover, overly complex requirements would favour the largest players. Therefore, a balance needs to be struck also between granularity of target market requirements and practicability in terms of compliance.

    Moreover, the paragraph states that, when defining the actual target market for products, distributors should use consistent terms and definitions and should ensure consistency between the actual target markets defined for products with homogeneous product features. If the terminology used by different product manufacturers is not harmonized, however, ensuring consistent terms and definitions in the actual target markets defined by distributors, who distribute products from many different manufacturers, will be an almost impossible task. Moreover, with the very different approaches, terminology and questions of the suitability and appropriateness tests used by different distributors, ensuring consistency of actual target market descriptions (which are largely based on potential target market descriptions of manufacturers) with suitability or appropriateness arrangements, will entail a huge workload for distributors who should then translate the terminology of the manufacturer in their own terminology, consistent between all products they offer ànd consistent with their suitability and appropriateness arrangements. In the opinion of the SMSG, the only solution is standardization. The more standardization in terminology there is, the easier the communication between manufacturers and distributors will be. If there is insufficient standardization in terminology, this will create misunderstandings and undermine investor protection. Moreover, this would lead to "closed shops" [see nr. 11 above]. The SMSG is of the opinion that standardization by the market is the most adequate process in this regard, whereas ESMA should stimulate this process and make sure that it uses those same market standards in its own regulatory work (see nr. 8 above).

35. Para 46: The SMSG advises ESMA to take into account the reality of distributors determining the actual target market of all products in their product range. This is an enormous task, and distributors cannot check every product detail (under IDD the distributor should not even define a target market at all; they can simply rely on the target market description of the manufacturer). The actual target market definition should, in the opinion of the SMSG, come down to a "sanity check", which consists of two elements: (i) is the potential target market definition of the product manufacturer not manifestly incorrect?; (ii) does the potential target market definition of the manufacturer fit the actual client base of the distributor, or are refinements needed in view of this actual client base. If the potential target market definition by the manufacturer is manifestly incorrect, the distributor should obviously reflect the necessary corrections in its actual target market description and give immediate feedback to the product manufacturer.

    This seems to be what the draft guidelines suggest in para 78, for products manufactured before 3 January 2018, and for which the manufacturer has identified a target market on a voluntary basis or on the

basis of commercial agreements. In such a case the distributor can rely on this target market description "after reviewing it with a critical look".

36. Para 56: The SMSG very much agrees with this new paragraph, meaning that if firms do not have sufficient client information to assess whether the client fits the target market, the firm can still sell the product to the client, after warning that the firm is not in a position to assess full compatibility of the client with the product. However, the statement that products should not be distributed under non-advised sales if the distributor cannot reasonably expect that the distribution strategy for the product will generally enable the product to reach the identified target market, is overly paternalistic. Firms will generally not know the investor profile of their execution only / non-advised clients; for more complex or risky products it will therefore not know whether the distribution strategy for the product will enable the product to reach the identified target market. This approach would ban the sale of complexer or riskier products via non-advised sales and unduly reduce the product offer for execution only clients. The SMSG advises ESMA to rephrase this sentence in the sense that the distribution strategy for riskier/complexer products should be thoroughly checked, especially regarding actively marketed products to the entire client base (e.g. the use of nudging and/or gamification techniques, 'finfluencers') (see also para 59, first bullet). The same argument can be made in respect of the example mentioned in the last sentence of para 55.

37. Para 59, first bullet: The SMSG advises ESMA to replace "behavioural finance" by "nudging".

38. Para 64: This paragraph states that "*Providing investment advice adopting a portfolio approach or portfolio management services does not exempt the firm from defining a target market for each product to be distributed and from monitoring deviations from the target market to ensure that products are only distributed outside the target market when this can be justified for diversification or hedging purposes*". However, limiting the possibility for an advisor or portfolio manager to deviate from the target market "only" when this can be justified for diversification and hedging purposes" seems inconsistent with para 84 that expressly states that "*There might be situations where products could, under certain circumstances and where all other legal requirements are met (including those relating to disclosure, suitability or appropriateness, identification and management of conflicts of interest), be sold outside the positive target market.*" The SMSG advises ESMA to explicitly refer to para 84-85 in the context of para 64, as follows:- "… *to ensure that products are only distributed outside the target market when this can be justified for diversification or hedging purposes, or in accordance with the procedures of para 84 or 85*."

39. Para 70: The SMSG advises ESMA to change this paragraph. A large number of manufacturers is not subject to MiFID II, including issuers of simple bonds and shares, investment funds, and third country manufacturers. If the distributor is not able or willing to devote the resources necessary to determine a target market for those products, or if the distributor cannot obtain sufficient information from the product provider and there is insufficient publicly available information available to identify the target market with sufficient granularity or certainty, the distributor is not allowed to include the product in its product assortment. The effect is, however, that European investors' access to foreign products is excessively reduced. The SMSG suggests that ESMA implements a two-step solution. First, if manufacturers do not provide target market information due to the fact that they are not subject to MIFID II, distributors could use the clustering referred to in para 47 of the draft guidelines as an instrument to efficiently define target markets for certain products. Plain vanilla shares/bonds could for instance be grouped into one cluster. Second, where the distributor does not possess sufficient information to identify the target market for a given product, this product should not be actively marketed or promoted, directly nor indirectly (e.g., through affiliated parties). However, clients who would like to invest in such products on an execution-only / non-advised basis should not be prohibited from doing so; product distributors should be allowed to exceptionally sell the product to clients who ask for such a product on their own initiative, subject to a clear warning that the product distributor has not been able to determine whether the client fits the target market for this product (in the same vein as under the circumstances of para 56 of the draft guidelines). While investors who are not aware of the existence of such products would in such circumstances remain unaware and thus not acquire it, more active investors who would want to invest in such products in an execution only / non-advised environment, would not be prohibited from doing so. In the SMSG's opinion, distributors should indeed be able to act as intermediaries for products which they do not actively promote

to their clients, but which a client would want to invest in on an execution only / non-advised basis, on its own initiative and its own responsibility, even without the distributor having defined a target market for such products.

40. Para 72: This paragraph states that distributors should determine what information they need in order to be able to draw reliable conclusions on whether products have been distributed to the identified target market, and not (systematically) outside it. To be able to draw such reliable conclusions, the guideline states that firms may need to gather further information about their clients, "*for example by sending a questionnaire to a sample of their clients that have bought a product under non-advised services*". The SMSG advises ESMA to delete this example since this requirement goes beyond the level 1 and 2 texts, would be very costly to implement, and would have a high probability of producing unreliable results.

41. Para 78: The SMSG advises ESMA to clarify what it means with "reviewing it with a critical look". As mentioned in nr. 30 above, the SMSG is of the opinion that this is also more generally the breath of the distributor's task in respect of the definition of the actual target market.

42. Para 86: The SMSG has three issues with this paragraph,[3] which reads as follows: "*For example, the sale of products outside the target market could occur as a result of non-advised sales (i.e. where clients approach a firm to purchase a certain product without any active marketing by the firm or having been influenced in any way by that firm), where the firm does not have all the necessary information to conduct a thorough assessment of whether the client falls within the target market, which might be the case, for instance, for execution platforms that only operate under the appropriateness regime. … Some firms could, for example, consider the possibility of not allowing clients to operate if they fall within the negative target market, while letting other clients transact on a financial product that is in the 'grey' area, i.e. between the positive and negative target markets*."

    First, this paragraph seems inherently contradictory. The paragraph starts by sketching a situation in which the firm does not have sufficient information about the client to be able to assess whether he or she falls within the target market – a situation which is also discussed in paragraph 56 of the draft guidelines. The paragraph ends, however, with the idea that firms can consider not allowing clients to purchase when they fall within the negative target market etc., which implies that an assessment of whether they fall within the positive, grey or negative target market can be made after all. This is a first reasons why the SMSG advises ESMA to amend this paragraph.

    Second, the situation envisaged in this paragraph – the firm does not have all the necessary client information to conduct a thorough assessment of whether the client falls withing the target market – is already dealt with in the new para 56 of the Guidelines, so this paragraph seems to have become redundant.

    A third issue is of a more fundamental nature, and again deals with the concern of the SMSG that a strict interpretation of the product governance guidelines could overly restrict the available product range, especially for non-advised retail clients. There is a real danger that investment firms, fearing liability claims or sanctions from the supervisor, become all too prudent and prefer an overly restrictive product range to risking liability or a fine. As a consequence, the range of products offered to large groups of retail clients is in danger of becoming ever scantier, until only the safest products remain available to them. Often only clients with a private banking profile – paying the correspondent fees for independent investment advice or portfolio management – get access to products with a higher risk, and a corresponding potential higher return. This is problematic, not only because in a low-interest environment the safest products barely promise any profits, but also because it makes it practically impossible for retail clients who opt for execution only to properly diversify their portfolios.

[3] See on those issues: V. Colaert, "Product Governance: Paternalism outsourced to Financial Institutions?" (2020) European Business Law Review 977-1000, at 993-998.

Under the MiFID I regime, the investor in principle always had the last word on non-advised sales: the financial institution had to warn against investments which it deemed inappropriate for the client, but the client could persist and nevertheless acquire the product. Likewise, in an advice environment the investor could always go against the advice of the distributor. The MiFID II product governance rules seem to have a different effect. Even if an individual client understands and accepts all the risks involved in a certain product, he or she will in principle not be able to acquire it, if the product distributor decides that the client falls outside the target market for the product. The only exception also lies in the hands of the product distributor, who can decide that there are exceptional circumstances and for that reason, after special motivation, agree to sell outside the target market. Distributors do not seem inclined to make such exceptions for their 'ordinary', non-advised retail clients (who, for instance, do not qualify for a "private banking" status).

Product governance measures thus threaten to impair non-professional investors' access to investment products to a much greater extent than the product intervention measures which supervisors can take. The MiFIR product intervention possibilities explicitly allow national and European supervisory authorities to intervene in order to restrict or prohibit the sale or marketing of certain extremely high-risk products to certain categories of investors. Such measures, however, are subject to strict procedural conditions. Supervisors are rather reluctant to make use of this option, and rightly so. That financial institutions can, on their own initiative, deny large categories of investors access to a much wider range of products seems very far-reaching in this respect.

This criticism does not detract from the positive effects of product governance measures in structurally reducing the danger of mis-selling. Without losing protection for the mass of less-informed investors, the product governance rules could avoid the perverse effect of overly restricting the product range, especially for non-advised retail clients, by an amendment of the guidelines. The amendment would clarify that (i) financial institutions should never actively market or offer a product to a client who falls outside the target market for that product, but that (ii) if a non-advised client nevertheless wants to invest in such a product, he or she should be able to do so at his or her own initiative and responsibility, subject to the motivation and reporting duties applicable to sales to clients outside the target market or in the negative target market. The amendment could explicitly clarify that such a motivation could be standardized and refer to the mere fact (i) that the client has been warned that he or she does not correspond with the target market for that product, (ii) that he or she was explicitly informed of the concrete risks he or she runs by investing in the product, but that (iii) the client nevertheless wished to acquire the product on his or her own responsibility. While the majority of retail investors will typically remain unaware of the existence of products for which they fall outside the target market (no marketing), and thus not acquire it, more active investors who would want to invest in such products and are willing to bear the related risks, would not be frustrated.

This amendment could be implemented in paragraph 86 and the addition of a new paragraph 86bis of the ESMA Guidelines.

The SMSG proposes to amend the draft guidelines as follows in order to deal with the above two issues: either delete para 86 (which deals with the same issue as para 56), or adapt it as follows, and add a new para 86bis as follows:

"86. For example, the sale of products outside the target market could occur as a result of non-advised sales (i.e. where clients approach a firm to purchase a certain product without any active marketing by the firm or having been influenced in any way by that firm), where the firm does not have all the necessary information to conduct a thorough assessment of whether the client falls within the target market, which might be the case, for instance, for execution platforms that only operate under the appropriateness regime. ~~Some firms could, for example, consider the possibility of not allowing clients to operate if they fall within the negative target market, while letting other clients transact on a financial product that is in the 'grey' area, i.e. between the positive and negative target markets.~~ In such cases, the distributor should warn the client that the firm has insufficient information to assess whether the product is

compatible with the needs, characteristics and objectives of the client. If the client nevertheless wishes to place the order, the company can execute it.

86bis. If the investment firm does have sufficient information to assess whether the client falls within the target market, and concludes that the client falls outside the target market of the product, the firm should refrain from actively marketing that product to the client, either directly or indirectly, and from influencing the client in any other way. If a client would, however, approach a firm in order to buy a certain product which has not been actively marketed or promoted in any way to the client, the distributor should warn the client in the most explicit terms that he or she does not correspond with the target market for this product, and explain the risks for the client if he or she would nevertheless invest in this product. This warning and explanation can be provided in a standardized manner. If the client persists, the firm can execute the order. The financial institution should motivate and document such a sale outside the target market (see paragraph 84-85). Such motivation can include the fact (i) that the client has been warned about the fact that he or she does not correspond with the target market for that product, (ii) that he or she was explicitly informed of the concrete risks of investing in the product, but that (iii) the client nevertheless wished to acquire the product on his or her own responsibility."

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA's website.

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[signed]

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