Finanzgruppe
Deutscher Sparkassen- und Giroverband

Response

ESMA Consultation Paper „Guidelines on certain aspects of the MiFID II suitability requirements“ (ESMA35-43-2998)

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Identification number in the register: 62379064909-15

Berlin, 07-10-2022

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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.

We have the following comments on the proposed supplementary requirements for determining the manufacturer's target market in para 13 et seq:

1. **Documentation of choices made (para 13)**

In para 13 ESMA wants manufacturers and distributors to document the choices made in the context of their product governance processes. This obligation is too far reaching as we have to have in mind that certain parameters of the target market definition are regularly reviewed. For example, the PRIIPs SRI is calculated on a daily basis.

In our view, ESMA should therefore focus on the major choices to be documented.

2. **Quantitatve and qualitative elements (para 14)**

In our view, it should be left to the manufacturers to determine which data they use to define the target market. At most, general guidelines should be established here. For this reason, we are rather critical of the special emphasis that quantitative elements should be supplemented by qualitative elements. In any case, the specifications in this regard should not be tightened further.

3. **Determination of the client category (para 19 a)**

The addition of the reference in para 19 a) that the manufacturer who wants to invoke the exemption in Art. 16a) MiFID II should consider before releasing the product whether it is really only to be distributed to eligible counterparties and is therefore covered by the exemption is understandable.

In our opinion, however, the reference to possible misuse, which can be understood as a general suspicion, should be omitted.

4. **Determination of the risk-return profile (para 19 d)**

It is positive that ESMA in principle wishes to continue to adhere to the legally prescribed risk indicators. With regard to the SRRI, however, a note should be added (e.g. in a footnote) that this will presumably only play a subordinate role (if not become obsolete altogether) after the PRIIP Regulation is extended to funds from January 1, 2023.

However, we are very critical of the additional requirement that the statutory indicators be corrected if they do not accurately reflect the risk of the product. This requirement would have the consequence that the product risk shown to the investor in the relevant information document (e. g. the PRIIPs KID) and the product risk used in the target market defintion could diverge (PRIIPs: SRI 4; MiFID: SRI 4 plus additional risk). The use of different product risks under MiFID and PRIIPs would be very critical, as it would hardly be comprehensible for investors. At this point, it is worth mentioning the different product costs that have been shown to investors for years under MiFID and PRIIPs and represent one of the biggest problems of investor protection regulations. This problem of non-harmonized specifications should not be transferred to the target market under any circumstances.

Furthermore, the correction of the risk indicator proposed by ESMA is not necessary, as such a mechanism will already exist for the calculation of the SRI under the PRIIPs Regulation as of January 1, 2023. Thus, the new PRIIPs RTS (COMMISSION DELEGATED REGULATION (EU) 2021/2268 of 6 September 2021) provides in Annex II point 52a the following requirement for manufacturers to correct an SRI that does not adequately reflect the risks of the product:

> *"52a. Where the PRIIP manufacturer considers that the summary risk indicator number assigned following the aggregation of market and credit risk in accordance with point 52 does not adequately reflect the risks of the PRIIP, that PRIIP manufacturer may decide to increase that number. The decision making process for such an increase shall be documented."*

This means that the manufacturer would already have to amend the SRI calculated in accordance with the statutory methods under the PRIIPs Regulation if it believes that it does not adequately reflect the risks of the product.

There is therefore no need for a further corrective as part of the target market determination under MiFID II, so that the requirement in paragraph 19 d) to amend the SRI if necessary should be dropped. Instead a reference to the requirement under the PRIIPs-RTS should be introduced. In this way, the synchronization between product risk under MiFID and PRIIPs is maintained and further frictions are avoided.

5. Fine tuning of the investment objectives (para 19 e)

We are critical of the fine-tuning of investment objectives proposed by ESMA, as it will hardly be possible at manufacturer level to make a statement that a product is aimed at specific age groups, for example. Here, it should remain with the proven criteria of „asset optimization", „over-proportional participation in price changes", „specific pension scheme" and „hedging".

To the extent that ESMA wishes to retain the fine-tuning, it should in any case be optional - as provided for in the draft.

6. Mandatory indication of the investment horizon (para 19 e)

The requirement that the target market should in future always include a statement on the investment horizon is understandable in view of the intention to further develop the guidelines. However, further additions to the target market criteria (in addition to the investment horizon and sustainability as already proposed in the Consultation paper) should be omitted.

With regard to the concrete interpretation of the criterion, ESMA's draft focuses on years. In practice, many distributors work with treadmills such as short-, medium- and long-term (that correspond to predfined timelines: up to 3 years: short-term - 3 to 5 years: medium-term - more than 5 years: long-term). This should also be allowed in the guidelines in order to leave distributors a certain flexibility in the implementation of the new requirement and to enable them to continue to work with the established processes.

Furthermore, we have to have in mind that it won`t be possible to define the investment horizon for products without maturity such as funds or shares in years. If a certain year would be communicated to the investor, he would get the wrong impression that the product (e. g. a share) gains a good performance in the respective year. This false impression must be avoided by not having to adhere to years when defining the investment horizon.

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 welcome ESMA's clarification in para 20 that the sustainability factors are the product-related counterpart to the customer's sustainability preferences. It is essential that there is consistency in content between the requirements of product governance and those for investment advice, so that distributors can use the target market data defined by manufacturers for the duties incumbent on them in providing advice or portfolio management.

In our view, this goal is achieved by the present draft guideline. When finalising the Guidelines, the additional option to declare whether the product has a focus on either E, S or G, that goes beyond the definition of sustainabilty preferences, should remain optional (as proposed in the Consultation Paper).

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.

As we understand it, the minimum proportions can in principle be calculated for all products in the scope of the SFDR. For most products that are not subject of the SFDR (i. e. bonds and shares) there is no requirement to define a minimum proportion. For these products there is no minimum proportion available that can be used for the definition of the target market. For these products where a minimum proportion is not available, it should be allowed to use the current proportion of sustainable investments.

Apart from that, the problem for investment firms is that many companies from the real economy are not obliged to calculate and report the Taxonomy-alignment of their economic activities until 2023. For this reason, there is simply a lack of data at present, so that many manufacturers of financial instruments are unable to calculate percentages and report a "0" due to a lack of data. In this respect, it would have been imperative to harmonize the different requirements in terms of time in order to avoid the currently observed low product spectrum. ESMA and the national NCAs should be aware on the practical issues when finalising the Guidelines and later on implementing them in practice.

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.

We reject the requirement in paragraphs 24 and 25 of the draft Guidelines that the target market is to be determined more granularly for complex products. On the one hand, there is the problem here, also addressed by ESMA, that there is no clear definition of complexity, but only the (inappropriate) differentiation between complex and non-complex, which is relevant for the question of whether a product may be marketed without an appropriateness test. The current interpretation is that alle bonds issued by banks or savings banks are decared as complex (also the simplest investment products such as fixed-rate bonds or floaters, as these can in principle be subject to a bail-in (see ESMA Guidelines on complex debt instruments and structured deposits, ESMA/2015/1787, page 9: "debt instruments eligible for bail-in tool purpose")).

The strong emphasis on complexity and associated obligations thus creates a great deal of legal uncertainty as there is no suitable definition.

In our view, this problem can be mitigated by focusing not on a more granular target market definition, but on a particularly careful and - if necessary - narrow definition of the target market for products that are particularly complex and/or risky. This is also consistent with

the requirement in paragraph 26 of the draft guidance that products such as CfDs should have a correspondingly narrow target market. A more granular determination of the target market (in the sense of determining additional criteria) is not necessary for this purpose, as the special features of the CfDs mentioned as examples can be taken into account via the existing criteria „client category" (only professional clients), the knowledge and experience (high knowledge and experience required), the investment objective (over-proportional participation in price changes) and the risk-return profile (CfDs should generally have an SRI of 7). This narrow definition would mean that only a very small group of investors would be within the target market of these products.

We also reject the reference in paragraph 27 that, in the context of the target market definition of the products, a clustering of similar products should not be possible in the case of particularly complex products. On the one hand, there is the aforementioned problem of the lack of a definition of complexity. In addition, we do not consider the restriction to be appropriate. The question of clustering should be based solely on the comparability of the product structure. If this permits a uniform target market definition, this must also be possible for complex products. There is, of course, the additional requirement that the target market for a particularly complex and high-risk product must be determined particularly carefully and - if necessary - also correspondingly narrowly. In the case of comparable product structures, however, this requirement can be observed uniformly for several products, so that there is no need to restrict the cluster option (see as an example the abbove mentioned target market for CfDs).

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.

We find it understandable and positive that ESMA takes into account new developments such as behavioral finance and gamification in the distribution strategy of distributors. Insofar as such forms of distribution are used, a conscious decision should be made on this as part of the definition of the distribution strategy and a check should be made as to whether these could lead to false incentives for investors. The same applies to the question of which products are actively advertised. Such decisions should also form part of the distribution strategy.

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.

In the past, we have repeatedly expressed our doubts as to whether the distributor`s obligation to determine a separate target market is in line with the Level I requirements, according

to which the distributors must take the manufacturer's target market into account in their sales activities. These doubts still persist.

To the extent that - as suggested in paragraph 42 of the draft - it is meant that distributors "translate" the manufacturer's target market into a "language" that fits their distribution processes (e. g. internal rsik indicators derived from the SRI that has been calculated by the manufacturer), we agree with the addition.

On the other hand, we take a critical view of the reference in paragraph 46 that distributors should, if necessary, request further results from the product approval procedure from the manufacturer. This requirement can hardly be implemented in mass retail business and should therefore be dropped.

On the other hand, the reference to the possibility of clustering similar products in paragraph 47 is positive. This helps distributors to make sense of the large number of target markets (in Germany, as far as we know, there are 1.8 million instruments with a target market). Without such a cluster possibility, this undertaking would simply be hopeless.

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.

It is very positive that ESMA explicitly states in para 59 that very complex and high-risk products can be distributed by way of advice-free business. This corresponds to the expectations of many customers, who rely on the distributor to execute the order they have placed. Where this is not possible (as, for example, in the case of bonds with a make-whole clause where there is no PRIIPs KID), this leads to annoyance on the part of the investors concerned. Any restrictions on sales to self-deciders would therefore be at the expense of investors.

In this respect, the focus of the explanations should be placed even more strongly on special sales forms such as gamification or the active promotion of products by distributors. Here, the requirement to review these measures as part of the definition of the distribution strategy makes perfect sense. This is different - as mentioned at the beginning - when the investor acts purely as a self-decider and the institution executes the customer order without any active sales measures with regard to the product.

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.

The restriction proposed by ESMA that target market deviations in the criteria of client category and knowledge and / or experience in portfolio advice cannot be based on the portfolio effect or the aspect of hedging seems understandable.

With regard to portfolio management, we want to point out that the investor has asked a professionel portfolio manager to take the investment daecisions on his behalf. This clearly demonstrates that the investor does not necessarily have the expertise on all products purchased by the portfolio manager since he has seeked for professionel help.

We would therefore advice to limit the restriction to portfolio advice.

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.

The general statements regarding the need for a review of the product release procedure in paragraphs 67 and 68 seem understandable to us.

On the other hand, the statement in paragraph 72 that distributors should, if necessary, obtain supplementary information from customers in order to be able to assess whether the products have been distributed in accordance with the target market is highly critical. We reject this requirement. Thus, distributors have all the customer information they need for the target market test in the respective service. Based on this, they can determine whether the respective product was distributed inside or outside the relevant target market. No further precautions are required, nor would they be feasible in mass retail business.

Another positive aspect is the clarification in para 72 that a product that is no longer sold is no longer subject to the review processes, even if clients still hold it in their deposit.

Nevertheless, we would recommend to modify the exemption for cases that the advisor recommends to hold the relevant instrument. An obligation to review the respective product should only be foreseen if the product is regularly subject to hold recommendations.

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.

The inclusion of a note in para. 81 that no negative target market determination is required for the sustainability criterion for products with sustainaility factors is generelly positive. The clarification that this does not apply to the other target market criteria and that a negative target market must be determined here (if necessary) and checked in the sales process is also useful.

Apart from that, we have doubts if the constellation, that a product has sustainability factors and there could nevertheless be the possibility that a negative target market needs to be defined, is relevant in practice. From our understanding there should be a general waiver to define a negative target market with regard to the new criterium of sustinablity for all products. With other words: With regard to sustainability only a positive target market needs to be defined. That would take account of the fact that sustainability is a subordinated aspect both in investment advice and under product governance.

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.

It is very positive that ESMA has incorporated the exemption for products distributed only to eligible counterparties introduced by the MiFID quick fix into the guidelines and intends to delete outdated explanations in the current guidelines.

With regard to paragraphs 94 and 95, we would like to point out that the presumption on knowledge and experience applies to all professional clients. The differentiation between per se and elected professional clients only plays a role in the presumption of financial circumstances. These may only be assumed for per se professional clients. This aspect should be adjusted accordingly when finalizing the guidelines.

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

The current guidelines are already very long and contain a great deal of detail. This is even more the case with the proposed additions by ESMA. For this reason, the good practice examples should not become part of the guidelines under any circumstances.

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

The current guidelines are already very long and contain a great deal of detail. This is even more so due to the proposed additions by ESMA. For this reason, the case studies should not become part of the guidelines under any circumstances.