NVB-antwoord op ESMA Leidraad Product Governance

Highlights

- **Conceptual error** - ESMA believes most financial instruments (shares, bonds and derivatives) are manufactured by investment firms. In reality these instruments are issued by companies, governments or exchanges, not by investment firms. Defining target markets and conducting reviews, is legally the responsibility of the manufacturer. If this 'manufacturer' does not exist, the burden of these assessments should not be shifted to the level of the distributor. For example, we believe that distributors in principle should be able to rely on the correctness of the information regarding the target market provided by the manufacturer. We do not need to re-do the manufacturers 'homework'.
- **Sustainability** - On sustainability, these draft guidelines are based on and aligned with critical concepts in ESMAs guidelines on suitability requirements. However, these suitability guidelines themselves are still only available in draft. Preferably, the timelines should have been better aligned between the legislators and regulators.
- **Definitions** - The definition of "*sustainability related objectives*" is not the same as the wording of the definition of "*sustainability preferences*". The current wording of "*sustainability related objectives*" aims a broader scope. Also, 'any' sustainability related objective is very broad and will lead to different interpretations in the market. Also, it is not clear what a "*sufficient level of granularity*" is. Furthermore, *"sustainability factor*" seems to encompass even another scope. The magnitude of different definitions will hamper understandability and comprehension by both professionals and consumers.
- **Complex products** - What is a complex product and what is not, is quite clear from the legislation. We ask ESMA to either refrain from using 'complexity as a relative concept'.
- **Deviation possibility –** We wonder why ESMA mentions two specific categories, as appropriate reason for deviation of the target market. We do not see why Knowledge and Experience or Type of Client should obstruct a distributor to gain diversification advantages. We believe it would be better if ESMA deleted these two examples in the guidelines.
- **Professional clients -** In paragraph 17 it is stated that manufacturers should not exclude any of the five categories. In case the type of client is professional, the categories knowledge and experience, financial situation with a focus on ability to bear losses and risk tolerance and compatibility of the risk/ reward profile seem not that relevant. This would also be in line with the suitability requirements in case of investment advice or portfolio management provided to professional clients. We refer to article 54, paragraph 3 of Commission Delegated Regulation 2017/565. Alternatively a proportionate approach in line with the treatment of professional client under the suitability requirements, should be acceptable.
- **ECM/ DCM business** - On the basis of recital 15 of Commission Delegated Directive 2017/ 593 and article 9 under paragraph 1, investment firms supporting the issuance/offering of securities by corporates are deemed to act as the manufacturer although they are not. This causes problems for the Equity Market (ECM) and Debt Market (DCM) activities of investment firms, in particular with regard to reviews. In relation to the aforementioned transactions, investment firms provide services like advice, underwriting and placing of the securities. The fees paid by corporates are related to these services. After the relevant transaction, the services are ended and no ongoing fees are paid by corporates. Therefore, there is no ground nor purpose for ongoing review of individual securities (ISIN) by investment firms which have been involved in a corporate issue in the past.

  The corporates take the responsibility for the issued securities themselves. Normally these securities are traded on secondary markets (no specific distribution channels) and the corporate takes care of the publication of relevant information related to the securities e.g. public disclosure of inside information and through custody chains (e.g. on the basis of MAR, PR, TD and SRD 2). Investment firms providing investment advice, portfolio management and execution only services use this information as distributor for their reviews. Involvement of external parties like investment firms which were involved in a corporate issue in the past, doesn't have any added value.

Therefore we would propose to add an exemption from the review requirement set out in paragraph 68 of the guidelines for so-called 'one of' or 'initial' manufacturers being investment firms involved in initial corporate issues but not in the full product cycle following the creation and placement of the relevant financial products essentially codifying current market practice. Should this not be possible, we would advocate to at least apply a proportionate approach with regard to reviews in relation to investment firms which have been involved in a corporate issue. We refer in that context to point 57 of the ESMA product governance guidelines of the 2th of June 2017. Reviews by these firms could be more generic on the type of instruments in relation to their services provided as accompanying investment firm and not on individual financial instruments (ISIN).

***

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.

In Paragraph 14 of the draft guidelines, ESMA 'suggests clarifying that, for the purposes of the target market identification, manufacturers should also take into account the results of the scenario and charging structure analyses undertaken for the relevant product.'

Most financial instruments (shares, bonds and funds) are not manufactured by investment firms but issued by companies, governments, investment funds. i.e., who can be identified as the manufacturer of an S&P-500 stock after issuance? This is a conceptual error in MiFID/Delegated Directive. Result is that most issuers of investment instruments don't qualify as manufacturers and thus are not legally required to provide any target market information at all. This puts the burden on distributors to collect this information. In the guidelines ESMA refers to 'manufacturers' as if every financial instrument is indeed 'manufactured' with an identifiable company as 'manufacturer'. The issuer however doesn't qualify as manufacturer (because it is not an investment firm). Ahead of issues or offerings of securities by corporates, the banks assisting the relevant corporate with such a transaction, are subject to MiFID and are considered to be 'manufacturer' instead of the actual issuer, please also refer to our answer to Q9 below. After completion of the transaction their involvement ends and there, thus, is no manufacturer that performs any 'scenario and charging structure analyses', leaving distributors with the unduly task to perform these analyses. Furthermore if there is no investment firm subject to MiFID involved, there is no manufacturer involved at all which means also no review by a manufacturer in any case. Nonetheless, the guidelines require distributors to proactively provide manufactures with relevant information to support reviews. Who should distributors provide the information to? We ask ESMA to specifically clarify this.

In paragraph 17 it is stated that manufacturers should not exclude any of the five categories. In case the type of client is professional, the categories knowledge and experience, financial situation with a focus on ability to bear losses and risk tolerance and compatibility of the risk/ reward profile seem not that relevant. This would also be in line with the suitability requirements in case of investment advice or portfolio management provided to professional clients. We refer to article 54, paragraph 3 of Commission Delegated Regulation 2017/565. Alternatively a proportionate approach in line with the treatment of professional client under the suitability requirements, should be acceptable.

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.

No, we do not. Some target market criteria can be derived from the type, nature and conditions of the investment instruments and/or regulatory mandatory disclosures regarding to these investment instruments (prospectus). This is however not the case for ESG factors.[1] The current target market criteria do not include or indicate the (environmental) activities and governance of the underlying

[1] SFDR Article 8 and Article 9 Funds: Q2 2022 in Review, p. 29 (link). This EET study shows that less than half of the EET is currently filled, with some indicators scoring only a coverage of 27%.

company/issuer. The target market criteria / ESG factors should be included in the regulatory framework applicable to the offeror/issuer of investment instruments (UCITS/AIFMD/Prospectus Regulation/etc.). As long as the “producers” of investment products are not legally required to provide information regarding to the ESG factors, it is not legitimate to put the obligation to provide the same information on the manufacturers (not being the issuers) and distributors. (If investment products are offered directly to the investor without the intervention of an investment firm the ESG-factors do not have to be disclosed!)

Manufacturers, distributors and issuers are only able to provide information on the identification of any sustainability-related objectives if these objectives are clearly defined. ESMA's Product Governance Guidelines, which will have to give concrete form to the amendments to the delegated directive published last year, are currently still in the consultation phase. However, the amended regulation will already apply from November 22, 2022. Because the Guidelines will be published not earlier than Q1 2023, investment firms do not have insight into the definitive requirements that should give concrete substance to their Product Governance framework. Additionally, the consultation refers to the sustainability preferences as defined in MiFID Suitability Guidelines. But these guidelins have not yet been finally published either. In addition, data arising from CSRD, SFDR and the European Taxonomy will not yet be available. For this reason, firms cannot comply with the obligation to check and document the sustainability related objectives and to ensure a sufficient level of granularity for each individual instrument whether that same instrument meets the criteria of a particular cluster or target market.

Also, ‘any’ sustainability related objective is very broad and will lead to different interpretations. We would like to plead for one market standard for ESG in product governance. Otherwise the danger exists that market parties can interpret ‘sustainable objective’ differently which will be confusing to clients and not in line with the market protection that product governance aims to achieve. Also adding so many parameters will complicate the product governance framework of distributors substantially and overshadows the more risk based topics within product government which aim to protect the investor. Also it is hard, if not impossible, to project these criteria objectively on instruments without a manufacturer (so other instruments than investment funds) if no market standard is set. In addition, it is important that there is alignment between regulations and definitions. The definition of “*sustainability related objectives*” is not the same as the wording of the definition of “*sustainability preferences*”. The current wording of “*sustainability related objectives*” aims a broader scope. And it is not clear what a “*sufficient level of granularity*” is. Also, *“sustainability factor*” seems to encompass even another scope. We ask ESMA to clarify this. Besides, we do not agree with ESMA to the extent ESMA notes that also sustainability factors that are not in scope of the SFDR and/or the Taxonomy Regulation should be taken into account.

Reference is also made to ICMA’s [and AFME’s] position. Given the extensive mandatory and market-standard disclosures regarding the nature of the product, the sustainability-related objectives shouldn’t be part of the manufacturers’ initial target market assessment. Additional requirements would prevent the smooth operation of the capital markets especially, in cases where the documentation (including the initial target market) shall be agreed upon by the syndicate banks at short notice.

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 mentioned in the guidelines itself, this applies to bond- and equity-instruments. Also as mentioned, the actual proportion can be used, but this actual proportion should come from the company or other issuer in case of bonds since otherwise this could lead to different interpretations. We ask ESMA to keep in mind that this is an EU regulation and only EU companies are required to comply with the disclosure obligations. We believe the information to determine the target market should come from the company itself and should not be calculated by the distributor in order to avoid discrepancies in the market.

For the same reason we do not think the proportion of sustainable investments should be used. While the concept of sustainable investments is defined in SFDR, how to measure it is not, nor is there an obligation for companies to disclose this. What is considered as a sustainable investment thus can differ between distributors considerably. We ask ESMA to clarify this.

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.

As with the previous ESMA consultation on Appropriateness, ESMA seems to indicate that there should be differentiation according to the type of (non-)complex financial instruments involved. So no one size fits all, but a tailor-made approach given the unique nature of every financial instrument. We strongly oppose the introduction of complexity as a relative term by ESMA in these guidelines. We ask ESMA to either refrain from using 'complexity as a relative concept' or to clarify the definition of 'complexity' legally. Paragraph 30 of the CP states: "while Article 25(4) of MiFID II contains relevant criteria and principles for determining a product's level of complexity, in ESMA's view, firms should not solely rely on the dichotomy between complex and non-complex products for the purposes of the target market assessment and should determine what factors make a product more or less complex (for example by considering its charging structure or its underlying assets)."

It would lead to legal uncertainty if investment firms no longer can rely on the qualification of financial instruments as being non-complex if these financial instruments are referred to in article 25 (4) (a) (i) to (v) MiFID II. Other financial instruments not in "this list" – such as AIF's / non-UCITS – can still qualify as non-complex if these financial instruments meet the requirements of article 57 Delegated Regulation (2017/565). Only latter article uses more open norms, for example: "adequately comprehensive information". These open norms could lead to different interpretations. We are however not aware that this has led to concerns and / or problems and thus needs "fixing". If such fixing would be required, we doubt whether the guidelines on product governance would be the appropriate document to do so.

In paragraph 27 of the draft guidelines it is stated that a clustering approach will not be compatible with OTC derivatives or structured products and that a definition of the target market should be done at the level of the individual product. We do agree that the more complex and risky financial instruments are, the more granular the target market has to be defined. We however do believe that also OTC derivatives and structured products can have so many elements in common that investment firms should be able to use the cluster approach. Think of interest rate derivatives for hedging purposes (amount and duration), guaranteed fixed income products, structured deposits, etc. The current proposal suggests that this clustering will no longer be possible for these financial instruments.

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.

ESMA seems to emphasize that the construction of the 'choice environment' should be part of the 'general consistency of the products and services to be offered to clients', however, 'it is distinct from the guidance on the distribution strategy for a specific product'. It is rather vague what is meant with the 'general consistency of the products and services to be offered to clients' and how/why this is different from the firms distribution strategy. We believe ESMA could further clarify why this should not be an integral part of the distribution strategy. It would also be helpful when ESMA clarifies the legal basis for specifying requirements around the choice environment, as we do not see this basis in MiFID II/delegated regulation.

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.

No, please also see our answer to question 1. Most financial instruments (shares, bonds and funds) are not manufactured by investment firms. This is a conceptual error in MiFID/Delegated Directive. Result is that most issuers / "non-manufacturers" of financial instruments are not legally required to provide any target market information. This puts the burden on distributors to collect this information.

In the guidelines ESMA refers to 'manufacturers' as if every financial instrument is indeed 'manufactured'. After issuance of shares and bonds however, there is no manufacturer that performs any 'scenario and charging structure analyses', leaving distributors with the unduly task to perform these analyses. In paragraph 40 of the CP ESMA writes that 'firms sometimes only rely on the 'outcome' .. without having access to the underlying or related documents that were used by the manufacturer in determining the target market for a given product. We wonder to what underlying or related documents

ESMA is referring to, because most financial instruments, do not seem to have a manufacturer in the first place. If ESMA believes the prospectus could be of any help for distributors, we would like to reply that this is not the case, as in the prospectus only some marginal information is available about the outcome of the target market assessment, but no information about the underlying analyses.

Furthermore we believe that distributors in principle should be able to rely on the correctness of the information regarding the target market provided by the manufacturer. Paragraph 46 of the draft guidelines suggests that the distributor needs to re-do the manufacturers homework and need *"access to underlying assessments"*. It is not only clear what the "underlying assessments are". Furthermore we believe this goes too far.

> *"To ensure a proper scrutiny of such more complex products, distributors should also determine whether, next to the manufacturers' target market description, they need access to underlying assessments such as the outcomes of the manufacturer's scenario and charging structure analyses. If, as a result of the process, the distributor comes to the conclusion that the target market of the manufacturer does not need to be refined, the distributor may use the manufacturer's target market as it is.*"

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.

In paragraph 43 of the CP ESMA suggests that distributors should 'refine the manufacturer's target market', especially for more complex products that have a relatively narrow target market.

Take as an example stock or index options, these instruments have no clear manufacturer that reviews the target market. Distributors will have to make their own analysis.

We ask ESMA to further clarify why the 'choice environment' is an essential part of the Product Governance requirements, but not of the distribution strategy (see our response before to q5).

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

We agree with the suggested approach on the deviation possibility for diversification and hedging purposes in general. However we do not 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.

We wonder why ESMA specifically mentions these two categories and ask ESMA to clarify this. From a practical perspective and as an example, if a firm offering portfolio management services, for diversification purposes, wants to invest in a hedge fund that is with professional investors as a target market, we do not see why Knowledge and Experience or Type of Client should obstruct the portfolio manager to gain these diversification advantages. We believe it would be better if ESMA deleted the two examples.

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.

On the basis of recital 15 of Commission Delegated Directive 2017/ 593 and article 9 under paragraph 1, investment firms supporting the issuance/offering of securities by corporates are deemed to act as the manufacturer although they are not. This causes problems for the Equity Market (ECM) and Debt Market (DCM) activities of investment firms, in particular with regard to reviews. In relation to the aforementioned transactions, investment firms provide services like advice, underwriting and placing of the securities. The fees paid by corporates are related to these services. After the relevant transaction, the services are ended and no ongoing fees are paid by corporates. Therefore, there is no ground nor

purpose for ongoing review of individual securities (ISIN) by investment firms which have been involved in a corporate issue in the past.

The corporates take the responsibility for the issued securities themselves. Normally these securities are traded on secondary markets (no specific distribution channels) and the corporate takes care of the publication of relevant information related to the securities e.g. public disclosure of inside information and through custody chains (e.g. on the basis of MAR, PR, TD and SRD 2). Investment firms providing investment advice, portfolio management and execution only services use this information as distributor for their reviews. Involvement of external parties like investment firms which were involved in a corporate issue in the past, doesn't have any added value.

Therefore we would propose to add an exemption from the review requirement set out in paragraph 68 of the guidelines for so-called 'one of' or 'initial' manufacturers being investment firms involved in initial corporate issues but not in the full product cycle following the creation and placement of the relevant financial products essentially codifying current market practice. Should this not be possible, we would advocate to at least apply a proportionate approach with regard to reviews in relation to investment firms which have been involved in a corporate issue. We refer in that context to point 57 of the ESMA product governance guidelines of the 2th of June 2017. Reviews by these firms could be more generic on the type of instruments in relation to their services provided as accompanying investment firm and not on individual financial instruments (ISIN).

In the recital / paragraph 48 of the CP / second bullet, we believe this should refer to paragraph 72 of the draft guidelines and not paragraph 73. Anyway, we oppose the wording of paragraph 72 and suggest to delete this paragraph. 72: ". For the purposes of their own review, 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, 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. Furthermore, firms should reconsider their distribution strategy for more complex products distributed through non-advised sales, if, for example, the review shows that such products are too often distributed outside the positive target market (or even in the negative target market)." Although we agree that firms could reconsider their distribution strategy, ESMA should delete the underlined part of the paragraph that hints to further questioning the client. This is part of the appropriateness process, not the product governance process.

Another important concern linked to the earlier point relates to the proposed changes to paragraph 73 of the draft guidelines. Initial manufacturers which do not execute reviews should not be confronted with a huge amount of data provided by distributors. This would only result in unnecessary additional work for distributors and a certain class of manufacturers being provided with huge amounts of data which they simply do not require. We would therefore appreciate your reconsideration of the proposed changes to paragraph 73 of the guidelines and keep the requirement for distributors to comply with information requests from manufacturers regarding information required in light of product reviews.

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

We agree with the approach that for products which consider sustainability factors, investment firms should not consider the sustainability-related objectives of the products when performing a negative target market assessment as this will limit the availability of products with sustainability factors for clients that do not have sustainability preferences.

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.

-

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

-

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

Case study 6, page 56, 4(b): a target market description of the specific option is shown that the client actively has to accept or reject. When the client rejects is, it is not possible to buy options. This should not be part of product governance rules. Product Governance does not relate to the provision of information to clients, but between manufacturers and distributors. Product Governance should also not require a client to accept or reject a target market description. Whether a client fits the target market should be part of the suitability or appropriateness assessment. The same goes for paragraph 5(b) on page 57. This should not be part of the product governance rules. Is it not the distributor that has to assess if the client understands the risks related to writing of options? Or can the distributor rely on this self-assessment by the client?

***