NORDIC SECURITIES ASSOCIATION

To:
European Securities and Markets Authority, ESMA

ESMA CONSULTATION PAPER ON PRODUCT GOVERNANCE DRAFT GUIDELINES UNDER MIFID II ESMA/2016/1436

The Nordic Securities Association is a Nordic cooperation that works to promote a sound securities market primarily in the Nordic region. The NSA is formed by the Danish Securities Dealers Association (Børsmæglerforeningen), the Federation of Finnish Financial Services (Finanssialan Keskusliitto), the Norwegian Securities Dealers Association (Verdipapirforetakenes Forbund) and the Swedish Securities Dealers Association (Svenska Fondhandlareföreningen).

Key issues

- The manufacturer and distributor should have the possibility to have a flexible approach regarding the identification of target market categories (i.e. the matter of proportionality), taking into account the nature and complexity of the products and the nature of firms´ business model.
- In the case of secondary market trading, investment firms advising in an IPO are not to be regarded as manufacturers.
- The extension of target market assessment to investment services is not in line with level 1 provisions.
- The NSA questions whether the criteria "risk tolerance and compatibility of the risk/reward profile of the product with the target market" should form part of the manufacturer's (and consequently the distributor's) target market assessment. This will impair the possibilities of offering all clients well diversified portfolios, both in a portfolio management and advisory context.

General comments

The NSA welcomes the ESMA's Consultation Paper (CP) on product governance requirements and specifically on the target market assessment. We fully support the objective of the product governance requirements i.e. to ensure that firms which manufacture and distribute financial instruments act in the clients' best interest during all

stages of the life cycle of the instrument. We also agree with ESMA that Guidelines on target market is important in order to ensure "the common, uniform and consistent application" of the MIFID II product governance requirements.

The NSA is generally supportive of ESMA's proposals and consider them to be well–balanced in many aspects. In particular we welcome that ESMA emphasises the need for proportionality and flexibility, taking into account the nature and complexity of the financial instruments as well as the firm's different business models/distribution channels. In fact, the NSA believes that well calibrated and proportionate rules are essential for the proper functioning of the product governance rules in MiFID II as well as in order to avoid unintended negative consequences e.g. for the open architecture or cross border business in EU.

However, in our opinion, a number of changes needs to be made throughout the draft Guidelines to clarify how the principle of proportionality can be taken into account at different stages of the process such as the identification of the target market by the manufacturer and distributor as well as the in their subsequent review. In order to ensure a uniform and consistent application of the rules, it would also be helpful to have more examples in Annex 4, for instance covering non-complex products (UCITS or listed shares) as well as the "negative target market". It would be particularly useful to have examples that cover all the stages of the product governance process, e.g. from the identification of the target market by the manufacturer to the review/reporting by the distributor and the possible amendment of the target market by the manufacturer. The manufacturer and distributor need to be able to provide a bulk target market assessment for non-complex products (such as UCITS or listed shares).

Furthermore, the NSA would like to raise two issues relating to the scope of the product governance requirements which we believe to be of particular importance that ESMA should clarify in the Guidelines.

The first issue relates to the application of product governance rules to investment services. We note that the rules on product governance in MiFID II apply to financial instruments and structures deposits. However, on level 2 (Article 10.1 MiFID II delegated directive) and also in the draft Guidelines, it appears as if the obligations for distributors have been extended to investment services i.e. not only products (paragraph 10 page 5 of the CP). The NSA questions if this interpretation is in line with the level 1 text. In our opinion, the reference to "services" in the delegated directive should only be understood as a reference to the obligation of the distributor to take into account which investment services it should provide as a part of its distribution strategy. It should not create a separate obligation for the distributor to assign target markets for its investment services per se, as paragraph 10 page 5 of the CP seems to suggest. Investment services such as investment advice or underwriting of financial instruments are to be left out of the target market assessment. Moreover, in NSA's opinion, the considerations when identifying a target market based on the proposed six categories would be quite different for investment services compared to investment products. In conclusion, we find that

investment services should not be in the scope of identifying target market. In case ESMA would however take the view that a distributor should also identify a target market for its investment services, it would be important to include clear examples in the Guidelines. To avoid legal uncertainty, the term "services" should also be replaced by "investment services" throughout the document.

The second issue relates to the application of the rules to secondary market transactions. The NSA notes that the term "manufacturer" under MiFID II includes "when advising corporate issuers on the launch of new financial instruments" (recital 15 of MiFID II delegated directive). Thus, to our understanding, investment firms providing services in relation to a primary market transaction (such as an IPO) could be considered manufacturers under MiFID II. However, what will apply for subsequent trading of the shares on the secondary market e.g. on a stock exchange? We note that ESMA in its technical advice also seemed to take the view that only the rules for distributors are applicable to trading on the secondary market (page 51 paragraph 4). In our opinion, it would not be reasonable if the investment firms (often there are several) involved in an IPO would be considered as manufacturers also in secondary market trading. Such interpretation would give rise to many difficult questions such as for how long those obligations will apply following an issue and how the distributors will even know who is manufacturer in respect of specific shares? In our opinion, the only workable solution for secondary market trading would be to consider the corporate issuer as the non-MiFID manufacturer. In practice, this would in many cases mean that it is the distributor that is required to assign a target market based on the public information included in a prospectus or other publicly available information alternatively enter into an agreement with the corporate issuer (article 10.2 third paragraph MiFID II delegated directive). This is a question of great practical importance and ESMA should ensure a common approach in all Member States.

As a final general comment, we propose that ESMA makes a thorough review of the terminology used in the draft Guidelines. As mentioned above, sometimes the term "services" is used and sometimes the term "investment services". In addition several new concepts are introduced without a definition which causes uncertainty as to their meaning (such as "sophisticated clients", "simple products", "common products", "actual target market", "potential target market", "innovative products" etc.). We call for the use of definitions already in use in financial services regulation. We also note that sometimes ESMA uses synonyms for what appear to be the same activity such as "target market identification", "target market definition" and "target market assessment" (although the latter term also seems to refer to the determination whether sales are within the identified target market?) The NSA firmly believes that a simple and coherent terminology in the Guidelines will add value for both firms and competent authorities and thus increase the level of convergence in EU.

Please find our replies to the questions below. We have in some cases included comments on the Guidelines even without a specific question from ESMA, in which case we have added references to relevant headlines and/or paragraphs in the document.

Questions

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

The target market criteria will be used in the information exchange between a vast number of manufacturers and distributors across Europe. It is important that firms are able to work with information points which are measurable and standardised. The NSA therefore generally welcomes the idea of a minimum list of defined categories which the manufacturer should apply when identifying the target market for a new product (or product type).

We also appreciate that ESMA recognises the need for a flexible approach as the manufacturer does not necessarily have direct contact with clients and therefore only can do an abstract target market identification (paragraph 12, page 6 of the CP). Thus, although a manufacturer in its internal product governance process will need to go through all six categories (i.e. the categories are cumulative), the principle of proportionality allows it to take into account the nature of the financial instrument and have a more high level approach for products which are non-complex (e.g. UCITS or listed shares) or for types of products which share the same characteristics (e.g. structured products with capital protection). See also reply to Q 2.

As regards the six target market categories, NSA has the following views and proposals:

<u>Type of clients to whom the product is targeted</u>

The rules on client categorisation in MiFID II clearly defines retail clients, professional clients and eligible counterparties. We therefore believe that ESMA should refrain from opening the door for additional types of clients in the draft Guidelines. Descriptions such as “sophisticated client” could have different meaning in different Member States and could make investors comparisons of products as well as cross border distribution more difficult.

<u>Knowledge and Experience</u>

There are clients which have no previous experience or knowledge of the financial markets at all. Since it must be possible for a client to “start” investing at a certain point in time, it should be possible to include in the target market that a product is compatible for clients with no previous experience and knowledge at all (e.g. for the most simple

mass products such as some types of UCITS). Similar clarification is also warranted for first time investors in more complex products.

Financial situation with a focus on the ability to bear losses

As regards the category "ability to bear loss" the NSA believes that it would be helpful if ESMA could introduce a fixed set of information points along the following:

a. The investor seeking to preserve capital or can bear losses to a level specified by the product structure

b. The investor can bear losses up to the invested amount

c. The investor can bear losses beyond the investment amount

Risk tolerance and compatibility of risk/reward profile

The NSA questions whether the criteria "risk tolerance and compatibility of the risk/reward profile of the product with the target market" should form part of the manufacturer's (and consequently the distributor's) target market assessment.

First, a client with a low risk appetite may very well seek to invest a small portion of its investment in high risk products where the portfolio as such still would have a low risk profile. Second, a financial instrument that objectively is deemed to be a high risk product could be used for hedging purposes to lift off risk in a portfolio or other types of risks in the investors personal life or business operations (typically interest rate and currency derivatives). Third, a high risk financial instrument may be regarded as a low risk instrument due to the investment strategy or diversity of the portfolio (e.g. off-setting derivatives or counterbalancing markets, individual products, or product types, etc.). Forth, a financial instrument deemed to be a high risk instrument on the face of it but acquired as a long time investment could be a low risk investment in a portfolio with a long time horizon. In all of these examples the client would be outside the target market but the investment as such (although being marked as a high risk product) would fit a low risk purpose.

Obviously, the proposed risk parameter and the risk/reward factor of the target market do not say anything of whether the financial instrument is suitable or appropriate for a specific client. Consequently, any risk and risk/reward parameter inclusion in the target market assessment may result in large client groups being barred from buying a vast number of financial instruments that both are common today and regularly trade by large non-professionals groups and are being deemed appropriate/suitable for the clients, since the distributor shall ensure that a financial instrument is distributed within the target market. If the intention of the legislator was to actually ban clients from buying products outside their deemed risk appetite the directive would have explicitly stated that and such an imposed limitation to an individual's or legal person's *legal capacity* to

trade would also have been subject to both democratic debate and proper legal discussion among the EU institutions.

In our opinion, the risk profile of a specific product better serve client protection purposes as an obligation on the distributor to convey to the client the specific risk and risk/reward profile of the product. A manufacturer's responsibility should be limited to produce such information on the specific financial instrument as specified in the existing EU legal acts, such as the directives and regulations related to prospectuses and collective investments respectively. The distributor is already under MIFID I (and will continue to be under MIFID II) required to provide the client with information on risks and appropriate warnings thereof. The client protection is well taken care of by the information obligations under MIFID II and the required suitability assessment/appropriateness test.

In regards to ensuring the possibility for advisers to provide solid and value adding portfolio advice it is necessary to bear in mind that risk assessed for a product considered separately is different to considering the overall risk of a portfolio based on an individual investors risk profile.

The risk of an investment product can for product manufacturers and distributors only be assessed specifically and not in the context of all theoretical portfolios constructed by an adviser – hence the manufacturer and distributor should assess the risk of the product but this should not limit the adviser's possibility to provide the client with a portfolio that matches the client's risk appetite/profile.

An example of a situation where an investor has a simple portfolio consisting merely of simple equity shares and simple covered bonds and sovereign bonds may help to illustrate the risk appetite/profile issue. Normally simple equity shares are considered high risk. If assuming shares are high risk products, a client with a medium risk profile could only be advised to hold a portfolio of covered and sovereign bonds. This entails three issues:

- Firstly, there is a risk that the client can only be advised to hold a portfolio with a too low risk profile (bearing in mind that taking too little risk compared to your risk appetite is also according to general economic theory resulting in a loss).

- Secondly, a portfolio that consists only of covered bonds and sovereign bonds is likely to have a different kind of risk/reward profile than a portfolio which invests only in shares. A client investing only in shares would have a portfolio with the same or lower overall risk due to diversification but would have a better expected return than the client investing only in bonds. Substituting a financial instrument with another financial instrument, which can be viewed as riskier, can form a portfolio of a reduced risk due to differences in correlation.

- Thirdly, if a client insists on having shares in their portfolio, an approach where advice can only in rare circumstances include financial instruments which individually viewed have a risk profile larger than the client's, could easily result in

clients increasing their risk profile to be able to receive advice on shares. The result of this is that the intended investor protection pushes clients to become more risky – that would not be beneficial neither for clients nor for advisers.

Regarding the portfolio risk approach, the adviser has a responsibility to assess the client's experience and knowledge. Therefore the adviser does not add more complex products to the portfolio but instead only keeps products which the client has the experience and knowledge to understand and handle.

There is also a crucial difference between PRIIPs and the proposed guideline. In PRIIPs the risk parameter and risk/reward factor are not part of the intended target market and are only part of the KID document as a prominent piece of information to the investor and as such attached to the product itself. In the draft guideline on the other hand the risk parameter is attached to the target market and therefore related to the specifics of the investor. For reasons explained above the "PRIIPs information only- approach" makes sense from an investor protection perspective whereas the inclusion of the risk parameter and the risk reward factor in the MIFID II target market does not.

Clients' Objectives and Clients' Needs

The categories "client objectives" and "client needs" should be merged into one as these points of information are closely connected. For instance, a product that is a "green investment" could typically be targeted for investors with an ESG-profile but this does not exclude that the product could also be compatible for a client without this specific need. Also, these categories could benefit from further standardisation based on the usage of a product, a fixed set of return profiles, access and time horizon. As objectives such as e.g. tax-issues and ethics could vary across markets, the objectives should be highly generic and should leave room for the distributor to perform the detailed assessment based on local practice.

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

The NSA generally agrees with the points made in paragraphs 18-20 of the draft Guidelines. In particular we welcome clarifications regarding bespoke or tailor-made products (paragraph 20). However, we see no reason to distinguish between "innovative" products and other products for the purposes of the target market identification (paragraph 18), in particular as no definition is proposed and it is therefore unclear which types of products are intended to be covered.

As mentioned in General Comments and in our reply to Q1, we generally welcome ESMA's statements regarding the need for a flexible approach as many manufacturers do not have direct contact with clients and therefore only can do an abstract target market

identification (paragraph 12 page 6 of the CP). Thus, although a manufacturer in its internal product governance process will need to go through all six categories (i.e. the categories are cumulative), the principle of proportionality allows it to take into account the nature of the financial instrument and e.g. have a more high level approach for products which are non-complex (UCITS or listed shares).

We support the two examples provided in paragraph 18 of the CP (page 7). According to the examples it would be possible to identify the target market categories on the basis of a common approach for all financial instruments of one type if such products are sufficiently comparable e.g. due to a regulated market. However, a similar approach for products of the same type should also be applied for more complex but "common" products of a certain type which share the same characteristics or features e.g. warrants or structured products with capital protection.

In order to ensure a similar application throughout the EU, we propose that ESMA includes some examples of identification of target market for non-complex products in Annex 4 such as UCITS and listed shares.

Articulation between the distribution strategy of the manufacturer and its definition of target market

The NSA does not agree with the approach that the manufacturer should provide or to go into details about the "preferred acquisition channel" (paragraph 22 page 24 of the draft Guidelines). This would create a grey area in terms of the division of responsibilities between manufacturers and distributors. Even though the draft Guidelines is worded in the sense that the manufacturer should specify the "preferred" acquisition channel, the manufacturer would in practice almost dictate the channel as ESMA in paragraph 38 on page 12 of the CP states that the distributor should generally only deviate from the manufacturer's distribution strategy in a manner which increases the client's protection.

In this connection, the NSA would like to recall that according to MiFID II, Member States shall allow firms to provide execution only services if certain conditions are fulfilled (article 25.4 MiFID II). Level 3 Guidelines should not be able to narrow down the scope of the level 1 by requiring that the manufacturer decides when execution only services are allowed. It must be the distributor that decides on the appropriate distribution strategy, taking into account the nature of the product and its client base.

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

Timing and relationship of target market identification by the distributor with other product governance procedures

The NSA agrees that the distributors' identification of the target market normally takes place at an early stage when deciding on the range of products to be distributed to which type of client and through which investment services (note that for bespoke products which are tailored for specific client's needs, the timing could of course be different). We also agree that the general aim of this identification of target market and determination of distribution strategy is to ensure that the product ends up with clients for whose needs, characteristics and objectives the product was targeted. However, as mentioned in our reply to Q 4, the portfolio of the client and other individual circumstances may allow the firm to deviate from the target market. In order to avoid uncertainty, a reference to paragraph 61 of the draft Guidelines could be inserted in paragraph 24 (page 25).

As regards the scope of distributors' obligations to identify a target market, the NSA notes that the rules on product governance in MiFID II apply to financial instruments and structured deposits. In our opinion, the reference to "services" in article 10 of the delegated directive should be understood as a reference to the obligation of the distributor to assess which investment services it should provide as a part of its distribution strategy. It should not be considered as a separate obligation for the distributor to assign target markets for its investment services (as paragraph 10 on page 5 of the CP seems to suggest), taking into account that no such obligation follow from level 1 (see also Q 8).

Finally, we take the view that paragraphs 23-27 of the draft Guidelines could be drafted in a shorter and more concise manner as regards the connection between the investment services provided by the distributor and the target market, in particular taking into account that this interaction is also developed in paragraphs 37-43 and 44-46 of the draft Guidelines.

<u>Relationship between the product governance requirements and the assessment of suitability and appropriateness</u>

The NSA notes that according to MiFID II, the requirements on product governance shall apply without prejudice to the MiFID II regulation on assessment of suitability and appropriateness (MiFID II article 25). Therefore, the rules in MiFID II according to which Member States shall allow investment firms to provide certain services to their clients without performing a suitability or appropriateness test (execution only) with "non-complex" products such as shares admitted to trading on a regulated market cannot be narrowed down by level 3, i.e. by making the distributor bound by a distribution strategy decided by the manufacturer, see above. Therefore, the distributor can continue to perform execution-only services with "non-complex" products without having to regard a distribution strategy set by the manufacturer.

<u>Identification of the target market by the distributor: categories to be considered</u>

The NSA agrees to the approach that in the target market identification, the distributor could generally use the same categories as manufacturers. As for manufacturers, the list of categories is cumulative but the contents flexible, i.e. the level of detail will, according

to the principle of proportionality, depend on the nature of the product and the investment services provided.

For instance, distributors should not be required to make a thorough target market assessment of products which can be deemed compatible with a mass retail target market (paragraph 41, page 29 of the CP).

The NSA also agrees with ESMA that the distributor should use as the starting point the target market information provided by the manufacturer. This information should be developed further into an "actual target" market, taking into account the distributors' detailed information on its own client base and its distribution strategy. We do however find the wording in the Guidelines somewhat contradictory as regards the possibilities to deviate from the target market identified by the manufacturer (cf. paragraphs 34 and 35 of the Guidelines, page 27). In our opinion, it must be possible for a distributor to deviate from the target market identified by the manufacturer. In fact, depending on the circumstances, the target market of the distributor should either be able to be more granular or wider than the target market identified by the manufacturer. The NSA proposes that this is principle is clearly stated in the Guidelines.

<u>Distributors' identification of target market – nature of the product (principle of proportionality)</u>

We agree that the same principle of proportionality should apply for the distributor as for the manufacturer and refer to our response to Q 2. It should also be possible to make "bulk target markets" for types of products which have the same characteristics, e.g. shares which are admitted to trade on a regulated market or structured products with capital protection.

More examples should be added in Annex 4 to clarify how the principle of proportionality can be applied for non-complex or products such as UCITS and listed shares.

<u>Distributors' identification of target market – interaction with investment services (principle of proportionality).</u>

As noted in previous parts in the response, although the type of investment services could be proposed by the manufacturer, it is always the distributor's final decision which services to provide to its clients.

We agree that the level of detail with which the distributor can identify target market will vary depending on the investment services in question. In fact, where the distributor provides investment services where it is not able to develop some of the target market categories e.g. due to lack of information on clients, it should be able to rely on the information provided by the manufacturer.

However, in practice the distributor would in many situations also need to take other factors into account when making its decision, such as additional information which the

distributor has access to through other channels and/or how specific and detailed the manufacturer has been when describing its target market.

It should be clarified what is meant by "recommend and actively market" a financial instrument (paragraph 43 of the draft Guidelines, page 29), as opposed to providing execution only services (paragraph 41 of the draft Guidelines, page 29). We note that according to the draft Guidelines, this distinction will have a significant impact on the scope of the obligations of the investment firm e.g. whether to conduct a "more thorough assessment of the target market assessment". In our opinion, a firm that only provides clients with the possibility to purchase and sell financial instruments on the Internet does not necessarily mean that the firm "recommends and actively markets" these instruments. Moreover, because of the current trend of digitalisation and development of financial technology (fintech), there should not be any distinct references to distribution channels because it may block the emergence of any new channels.

Furthermore, it is not clear from the draft Guidelines how the distributor's obligation to identify a target market interacts with its review obligation when it comes to the principle of proportionality. In NSA's opinion the scope of the review process should correspond to the scope of the target market identification process. For example, if a firm distributes instruments based on appropriateness test and only has access to information on clients' knowledge and experience it is this category which the distributor should evaluate in its regular review (i.e. not the other categories which the distributor may not have any information on due to the choice of distribution channel). On the other hand, if the firm provides investment advice and has made a more thorough target market identification, the regular review should normally encompass more categories. The question is important from a practical perspective and it would therefore be most welcome if this principle could be confirmed in the final Guidelines.

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

The NSA does not agree with the suggested approach. Considering that proper portfolio diversification is key to any client, independently of its characteristics or objectives, regulatory changes should promote it instead of inhibiting it. Diversification is a result of combining different risks, meaning that products with different characteristics and, a priori, with different target markets may be suitable when assessed within a portfolio approach. Therefore, deviations from the target market that result from a proper portfolio diversification should not be taken as exceptional but fundamental for investor protection (paragraph 61 of the draft Guidelines). In this sense, target market identification should not only consider the product when individually assessed but also when part of a broader investment portfolio.

Moreover, stating that sales outside of the target market should only be a limited occurrence opens the door for different supervisory approaches across Europe as it is a

highly subjective criterion. The focus should rather be on ensuring proper documentation of why a diversification has been made, and consequently why a sale outside of the positive target market has occurred. In NSA's view, the suitability report but also other documentation can be used for this purpose.

The NSA agrees with ESMA that there are situations where the same type of product could be used to meet different client's objectives or needs and therefore that it should be possible for the firm to identify from the beginning more than one target market of end-users (paragraph 34 page 11 of the DP). This is of particular importance for products with a risk profile that vary depending on the portfolio and investment horizon of the client.

The NSA also notes that while there is a discussion about hedging and portfolio diversification aspects in the preamble, we note that the topic is not mentioned in the proposed Guidelines. Since it is a vital part of distributors' operations, we would welcome references to hedging, portfolio diversification and client specific features in the actual Guidelines.

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

The NSA believes that further guidance is needed in respect of secondary market transactions. In our opinion, it would not be reasonable if (all) the investment firms which at one point in time have been involved in an IPO would be considered as manufacturers for subsequent secondary market trading. Instead, the corporate issuer must be considered as a manufacturer, i.e. in many cases a non MiFID firm. In practice this means that the distributor will be required to assign a target market for the instrument based on the public information included in a prospectus or other publicly available information alternatively enter into an agreement with the issuer. (Article 10.2 third paragraph MiFID II delegated directive).

With reference to paragraph 51 and 52 on page 31 we also seek confirmation that a non-MiFID firm operating in compliance with the MiFID II product governance obligations should not have to enter into agreements with their distributors to govern the product governance obligations.

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

The NSA supports that investment firms, when appropriate, should identify a negative target market as ESMA notes in paragraph 58 in the Guidelines. It is however important

that such an identification needs to be done only when such a negative target market is relevant. In cases where a product is not deemed incompatible with a specific group of client, e.g. mass market retail products, there can be no need to identify a negative target market. The negative target market should not be identified by simply taking the opposite characteristics of the target market but it should rather be an effort to identify those groups of clients that have incompatible needs, objectives and characteristics with the product.

In NSA's opinion, the concept of a "negative target market" is not clear and needs to be further clarified in ESMA's Guidelines. In our view, the level 2 text requires firms to "identify any groups of clients for whose needs, characteristics and objectives the product or service is not compatible". The obligation should be limited to the situations where a negative target market exists and can be followed up.

As mentioned previously in this response, diversification is also essential in order to provide adequate investor protection to clients. This means that a product where the investment objective speculation has been identified could very well be compatible for clients with a low risk profile when having the product as a part of a portfolio. Therefore the negative target market should be identified as a specific group of clients for which the product is incompatible if such a group exists. A too wide definition of the negative target market could have the unwanted effect as distributors are restricted from providing their clients with the product best suited for the clients' situation. A negative target market may therefore have an opposite impact on investor protection as intended.

If ESMA does not agree but considers that a negative target market should always be identified (and both by the manufacturer and the distributor), it should be clarified if this signifies that the negative target market should be considered as a seventh category?

Moreover, ESMA should provide further references in the Guidelines on how a negative target market should be identified for products which are aimed for the "mass retail market" and how firms providing execution only services or execution with appropriateness test should know if a product is sold outside or within the negative target market. Illustrative examples should be added in Annex 4.

To NSA's understanding, ESMA's thinking is that the target market process will lead to the identification of the positive target market, the negative target market and the area between the positive and negative target market. As discussed in our comments regarding Q4 the focus should be on the possibilities to sell products in the area between the positive target market and the negative target market due to diversification and the way that investment advisory processes are carried out. In this context, and due to the process of diversification, it is important to keep in mind that a distributor may occasionally be in a situation where it would make sense to include in the client's portfolio a minor holding in a product that, seen in isolation, would be within the negative target market. In these rare occasions of a sale within the negative target market, the distributor should of course document it and include it in the information to be provided to the manufacturer.

The NSA finds the phrase in the consultation paper paragraph 61 on page 33 "…to occur not on a regular basis" too strict because in practice there will be situations where the product is sold outside the positive target market. In a case of portfolio management, this should be allowed to happen and "not on a regular basis" does not fit in that scenario (see also Q4). Also if a client wants to purchase a non-complex product without appropriateness test (execution-only), the distributor should be able to sell it to them - if so, this should be clarified. Moreover, in order to avoid legal concerns regarding liability, it should be clarified that a distributor can advise a client to invest in a certain product even if that client is outside the assigned target market, provided that the product is suitable (i.e. following a suitability test).

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

In our opinion the Guidelines should not apply to professional clients and eligible counterparties. Alternatively, an investment by a professional client or an eligible counterparty should always be deemed to be within the target market. First, according to the MIFID II directive a professional client "is a client who possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs". Consequently, such a client has the necessary capability to understand and evaluate all six categories of the target market. Second, a professional client is either an institutional investor (such as a financial institution operating under specific permits, e.g. investment firms, credit institutions and insurance companies), large corporation that meets certain quantitative criteria set out in the MIFID II or national or supranational authorities such as central banks, offices managing national debts, ECB, EMF, the World bank, etc). The idea that an investment firm needs to protect these clients from making the investment decisions they deem necessary to meet their business needs or their public or governmental requirements seems to be ill conceived. Third, it cannot be in line with the intention and purpose of the MIFID II to hinder professional clients such as financial institutions to operate within their specific business authorizations, large corporates who operate within the confines of their commercial activities or national or supranational authorities to conduct their public duties. This reasoning applies even more so for clients classified as eligible counterparties.

These arguments apply equally to clients who have requested to be treated as professional clients given the very high qualitative and quantitative requirements set to be eligible for treatment as a professional client.[1] This conclusion is even more apparent given the fact that (i) the client must specifically state in which product or service he

[1] In the course of that assessment, as a minimum, two of the following criteria shall be satisfied:
— the client has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters,
— the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments exceeds EUR 500 000,
— the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged.

wishes to be classified as professional, (ii) the investment firm must give a clear warning of the protection and investor compensation rights he may lose, and (iii) the client must state in a separate document that he is aware of the consequence of losing such protection.

In case ESMA does not agree to the above proposals (i.e. to either exclude professional clients and eligible counterparties or to consider that an investment by a professional client or an eligible counterparty should always be deemed to be within the target market), it is important to consider the following: According to MiFID II level 2, when providing an investment service, an investment firm can assume that a professional client has the necessary knowledge and experience in order to understand the risks involved in the transaction or in the management of his portfolio (article 54 (3) and article 56 (1) of the delegated regulation MiFID II). In paragraph 72 of the Guidelines, ESMA writes about a distinction made in MiFID in assumed knowledge and experience between per se and elective professional clients. The NSA notes that such distinction is made in regard to the classification of clients. So in regards to certain customers an investment firm cannot presume knowledge and experience but should instead conduct an assessment of the clients' expertise, experience and knowledge. However when conducting both the appropriateness test and the knowledge and experience portion of the suitability test an investment firm can assume that a professional client has the necessary knowledge and experience for which the client is classified as a professional client. Since such assumptions are allowed whilst conducting appropriateness or suitability tests the NSA questions the value of any such distinctions when identifying a target market. An investment firm should instead be allowed to assume that a professional client, in regards to the target market, has the necessary knowledge and experience in relation to the products for which the client is classified as professional.

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

<u>No target market concept for investment services</u>

The NSA notes that the rules on product governance in MiFID II apply to financial instruments and structured deposits. However, on level 2 (Article 10.1 MiFID II delegated directive) and also in the draft Guidelines, it appears as if the obligations for distributors have been extended to investment services, i.e. not only products (paragraph 10 page 5 of the CP). The NSA questions if this interpretation is in line with the level 1 text. Moreover, in some parts of the draft Guidelines, the term "services" is used, which creates additional uncertainty as to the scope. In our opinion, the reference to "services" in art 10 of the MiFID II delegated directive should be understood as a reference to the obligation of the distributor to take into account which investment services it should provide as a part of its distribution strategy. It should not create a separate obligation for the distributor to assign target markets for its investment services, as paragraph 10 page 5 of the CP seems to suggest. We also note that ESMA in its technical advice explained that the term "investment service" related to the assessment that firms should do

regarding their distribution channels. It does not say that it is a requirement to identify a target market also for investment services (page 53, paragraph 10).

Target market for discretionary portfolio management

In relation to product governance rules and the target market required by investment firms we would like the ESMA Guidelines to take into account the peculiarities of portfolio management. On the contrary to what is the case for self-services and advisory, the overarching purpose with portfolio management is to deliver a management in line with the client's objectives and goals as defined in the contractual mandate between the client and the investment firm. The match between product, target market and individual client is therefore served through matching the client with the right mandate of portfolio management.

Co-manufacturers

With regard to the identification of the target market by the distributor, we think that the Guidelines do not sufficiently consider the case where two or more firms cooperate in manufacturing a financial product – thus being considered as "co-manufacturers". This case, instead, is considered under article 9 of Commission Delegated Directive of 07/04/2016 and also in EIOPA's consultation on product governance requirements under IDD. According to the definition provided in article 9, "manufacturing", can include both the activities of "issuance" and "design". However, it is common practice in the market that such activities are performed by different market participants who co-manufacture the product.

Exchange of information between distributors and manufacturers

With reference to the consultation paper paragraphs 47 – 50 on page 30, the information sharing between distributors and manufacturers and the periodical review process are still issues where we seek further guidance. This concerns for example the notion of the interpretation of the "proportionate basis" which manufacturers should use when collecting information for their review, whether in-active products should form part of the review process etc.

Given the huge amount of distributors and manufacturers within Europe we believe that a set of standard points of information is needed regarding the six categories. Otherwise we will run the risk of a very fragmented approach across Europe with divergent processes and quality. We underline that these standard points could be developed to help data transfers between the manufacturer and the distributor. Such a standard set should take its outset in the services provided by the distributor and the client type targeted and could include e.g. the following data elements from distributors to manufacturers:

- Distribution chain and channels
- Sales information – by distributor, sales strategy and client type

- Total sales
- Sales outside the target market
- Sales within the negative target market
- Assets Under Administration – by distributor and client type

We are also seeking further clarification as to what information on the product approval process a manufacturer would need to make available to distributors.

Regular review to assess whether products and services are reaching the target market

It needs to be clarified in the draft Guidelines how the review obligation interacts with the obligation to identify a target market and the principle of proportionality. In particular it should be stated that where a distributor has made a more restricted target market assessment and only taken a limited number of categories into account, the review process should have the same scope. For example, if a firm distributes instruments based on appropriateness test and only has access to information on clients' knowledge and experience it is this category which the distributor should evaluate in its regular review (i.e. not the other criteria which the distributor may not have any information on due to the choice of distribution channel). On the other hand, if the firm provides investment advice and have made a more thorough target market identification, the regular review should normally encompass more categories.

Moreover, the requirement to report deviations from the target market to the manufacturer should only apply to reoccurring or systematic deviations. The ability of a distributor to provide the manufacturer with information on deviations will depend on the investment services provided. For instance, the requirement does not seem well-adapted to the situation where execution only services are provided. How is an investment firm to know whether a client falls within the target market or not? The same problem occurs where a client refuses to provide information on knowledge and experience and decides to invest anyway (i.e. despite warning)?

Treatment of existing products

As regards the treatment of existing products, the NSA understands that the distributor should assign its own target market which will apply until the product has been under review by the manufacturer. The NSA wonders what will apply in a situation where the manufacturer following such review would decide on a target market and/or propose distribution channels that significantly differ from the one applied by the distributor (e.g. a negative target market that excludes the group of clients to which the distributor has sold the product). How is the distributor to act in such situation e.g. in relation to existing clients which have invested in the product based on the distributor's own target market assessment?

Annex 4 – need for more examples

The NSA finds the examples in Annex 4 of the draft Guidelines helpful and would like them to be developed further. As mentioned in the questions above, we would very much appreciate examples of more simple products such as listed shares and UCITS. Also examples of negative target market and an example of instruments traded on the secondary market would clarify many situations. Finally it would be useful if the examples follow all stages of the product governance process i.e. the "life cycle". Such a description could start with the identification of the target market by the manufacturer and end with the review and reporting by the distributor and possible amendment of the target market by the manufacturer.

Q9: What level of resources (financial and other) would be required to implement and comply with the Guidelines (market researches, organisational, IT costs, training costs, staff costs, etc., differentiated between one off and ongoing costs)? If possible please specify the respective costs/resources separately for the assessment of suitability and related policies and procedures, the implementation of a diversity policy and the guidelines regarding induction and training. When answering this question, please also provide information about the size, internal organisation and the nature, scale and complexity of the activities of your institution, where relevant.

The NSA has no comments at this stage.