Consultation Paper

ESMA Guidelines for MiFID product governance requirements

FINANCE DENMARK

Memo

August 26, 2022
FIDA-931287038-797042
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Introductory remarks

Finance Denmark thanks for the opportunity to express our view on the guidelines, including the suggested changes.

As a general remark on both guidelines, they should deliver a product governance and suitability assessment framework that reflect the great uncertainty under which the industry is currently implemented ESG into both suitability and product governance processes. We would in this regard refer to letters sent from both the Nordic Securities Association dated the 9th of June 2022 as well as the letter from numerous Industry Associations dated the 19th of July 2022. Both letters highlight and explain these uncertainties both with regards to regulation and data accessibility and propose directions for ESMA.

Finance Denmark would also like to point out that these guidelines should be kept within the scope and subject of the MiFID product governance requirements. Subjects related to suitability should be designated to the suitability guidelines to avoid confusion and increase transparency in the level three guidance.

The guidelines on suitability and product governance respectively are largely interdependent since client sustainability preferences must match the product offerings governed by the product governance processes (also referred to as POG processes in the following).

The fact that the two guidelines are not drafted, consulted on, and implemented simultaneously poses practical problems as well as legal uncertainties since the two guidelines touch upon the same or similar legal definitions from different angles. In addition, hereto, there is a risk that the guidelines may not be aligned when consultation processes are not. We urge ESMA to bare this in mind in the work of finalizing the guidelines.

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.

Finance Denmark welcomes further guidance on the identification of the potential target market for a given financial product by the manufacturer. However, except for the results of the scenario and charging structure analyses already mentioned in paragraph 14, Finance Denmark would like further examples of qualitative criteria that may be used for the identification of the potential target market for a given financial product by the manufacturer. As ESMA is probably aware many resources are already being devoted for operationalizing the product governance requirements, especially, with regards to dataflow between manufacturers and distributers through FinDatEx and common European data templates.

We would like to point out that it must be the content of the information and not whether it is quantifiable or not that should be the main focus for ESMA. Most information is quantifiable in one way, or the other and the growing POG requirements must be operational. In this regard, the thrive to increase the quality of the POG process and to increase value for money for end investors will push for operational ability in the POG processes. In this context, we could easily foresee a quantification of the two examples mentioned by ESMA being the results of the scenario and charging structure analyses. Perhaps, the purpose for ESMA is really to state that datapoints cannot blindly be used for TM evaluation in a strictly mechanical process. We would fully agree on this type of guidance. Perhaps the guidelines could reflect this in a more balanced wording instead of demanding the use of specific qualitative criteria or as second-best alternative provide examples of unquantifiable qualitative criteria.
Furthermore, Finance Denmark finds that the wording" without merging categories", in paragraph 16, is an unnecessary approach. In our opinion, there are cases in which it makes sense for the manufacturer to merge the categories mentioned in paragraph 19. This does not mean that the manufacturers will let any of the categories out in the process of identification of the potential target market but enables them to adjust their procedures accordingly to the given financial product and/or a given target market. For example, the categories "Financial situation with a focus on the ability to bear losses" and "Risk tolerance and compatibility of the risk/reward profile of the product with the target market", cf. paragraph 19, c) and 19, d), respectively, are not in all cases in practice separable as they touch upon materially the same matter from different perspectives. We, therefore, suggest that the wording "without merging categories" is deleted.

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.**

Finance Denmark highly appreciate the flexible approach laid down in paragraph 20 on the identification of any sustainability-related objectives.

However, the legislation on sustainability in general, including the mentioned regulations in the bullet points in paragraph 20, is evolving very quickly. It is also uncertain how the legislation will be applied in practice by NCAs. Also, the guidelines on suitability are not yet finalized and the link between the two guidelines are important to ensure consistency. In addition, there are great uncertainties and links to other regulations with timing inconsistencies as described in the letter to ESMA from European Industry organization dated the 19th of July 2022.

Finance Denmark can also support that it is stated in the guideline that in order to ensure a sufficient level of granularity of the target market, when identifying sustainability-related objectives, firms may specify, where relevant, aspects in line with the definition of "sustainability preferences" according to Article 2(7), of the MiFID II Delegated Regulation and as further detailed in the ESMA Guidelines on certain aspects of the MiFID II suitability requirements.

However, to avoid confusion, Finance Denmark find it to be of importance to ensure that exact same definitions are used across documents. Having this in mind, Finance Denmark suggest to delete the three bullets that are included as a part of paragraph 20 in page 29 which refer to taxonomy alignment (1st bullet), sustainable investments (2nd bullet) and PAI (4th bullet) and solely just refer to the definition of definition of "sustainability preferences" according to Article 2(7) of the MiFID II Delegated Regulation and as further detailed in the ESMA Guidelines on certain aspects of the MiFID II suitability requirements. In that way it can be ensured that no new definitions and interpretations of "sustainability preferences" are launched, having in mind that companies already today have made their own set up based on det current legal texts.

As also stated in our response to the suitability guideline consultation more flexibility with regards to the definitions og suitability preferences as well as sustainability-related objectives should be given at least in the short to medium term. Therefore, we welcome the term "firms may specify" in paragraph 20 and we would highly welcome the same flexibility with regards to the definition of sustainability preferences in the suitability guidelines. Implementing a similar wording in the suitability guidelines could accommodate the need for flexibility at least in the short to medium term as argued in the letter from the Nordic Securities Association dated 9th of June 2022 The change of wording would accommodate our concerns that the final ESMA guidelines on both suitability and product governance might not accommodate a best effort period and a relative and flexible approach as to what constitute a sustainable product in the product governance sustainability classification. In our view, investment firms must be allowed to evaluate the level of sustainability for a given product relative to the market at a given time against products with similar characteristics as well as enrich the product governance evaluation with datapoints not defined by SFDR and the taxonomy. These options are necessary for distributors to have products available for retail clients with sustainability preferences as well as continuously match best in class sustainable products with clients with high sustainability preferences. These options are important for distributors in the coming years as data coverage and quality will evolve at a fast pace.

Furthermore, it should be kept in mind that the product governance requirements apply to all financial instruments and not only financial instruments distributed through advice and as further outlined below, but the concept of minimum proportion is not practically applicable to certain financial instruments. Also, there is currently not data on the level of sustainable investments and PAI for other financial instruments than products subject to SFDR. Therefore, we support having the third bullet in paragraph 20 on page 29 as an alternative way of specifying sustainability related objectives for products that are not compatible with the elements in the "sustainability preferences". However, we suggest that it is elaborated further how to apply the 3rd bullet.

In addition, for products with no sustainability objectives setting the sustainability related target market should be an exercise as limited as possible.

Further, in order to streamline the guidelines, Finance Denmark suggests that paragraph 42 concerning the identification of the target market by the distributor should not only not only cross-refer to target market categories as defined in paragraph 19, but should also refer to paragraph 20) in order to ensure that the sustainability-related objectives mentioned in paragraph 20 is also covered. This would secure a better link between the manufacturers and distributors' processes of identification of the target market, respectively.

In relation to the suggested streamlining of paragraph 42, Finance Denmark would like to refer to our comments 1 concerning the wording "without merging categories". We would like to stress the same arguments concerning distributors.

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.

Finance Denmark understands the reasoning behind the minimum proportion. However, the concept of minimum proportion cannot be applied in practice to all relevant financial products and services covered by the guidelines due to a large lack of data to substantiate a minimum proportion of sustainable investments. See our answer to question 2 as well as our general introductory remarks.

This applies, especially, but not exclusively, to the following financial instruments:

- Derivatives
- Shares
- Bonds, including sovereign bonds

Derivatives
In the view of Finance Denmark, it is for most derivatives neither meaningful nor possible to operate with a minimum nor even a concept of sustainable investment. How sustainable is for instance an interest rate swap or a currency swap? Measuring the minimum proportion of sustainability of swapping a long interest rate for a short or vice versa can hardly in any meaningful way be done. It is problematic that regulation and guidelines in general include all derivatives as if these are investments as they are generally used for hedging purposes. There is a general lack of recognition throughout financial regulation that these types of positions should be handled methodically separate from investments. In the concept of sustainability measurement this general point becomes very clear.

Shares
Applying the concept of minimum proportion means that all economic activities of companies whose shares are distributed must be analyzed to establish what the proportion of sustainable economic activities for each share is. Unfortunately, at this point, these data for the vast majority of shares do not exist. Therefore, it will be nearly impossible for the manufacturers to specify any sustainable-related objectives or minimum of sustainable investments using the proposed concept minimum proportion.
The only way of doing so would be to apply proxy data instead. These data, however, may not have the desired level of precision and are only estimates. This leaves the manufacturers with a great risk of making unintended errors in the process and puts them at risk of being unfairly accused of greenwashing.

Bonds, including sovereign bonds
As for bonds, including also sovereign bonds, the same problems as described above apply. In addition, it is in practice not possible

to establish whether or not and to what extend proceeds of the issuance of e.g. sovereign-bonds are spend on sustainable activities or other economic activities.
Finance Denmark is aware of the fact that a few sovereigns are planning to or have already issued green sovereign-bonds for the purpose of financing sustainable investments and economic activities. However, this is only the case for a small number of sovereigns mainly in Europe. As a consequence, these green sovereign-bonds only constitute a very small and insignificant part of the sovereign-bonds market.

In other words, this means that the concept of minimum proportion, despite of its good intentions which we recognize, is not viable in practice at least not before markets and data availability matures.

Naturally, the remarks above also apply to UCITS or any other financial product containing any the of the above-mentioned financial instruments.

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.

Finance Denmark appreciates the possibility to use a clustering approach as this support operational ability. We also follow the reasoning behind the clustering approach as it eases the burden for the manufacturers and distributers of identifying the potential target market without lowering the protection of investors. Without this possibility product governance would not be operational. Finance Denmark also would like to stress that, in our view, and as is now also stated in the guidelines it is important that a principle of proportionality applies, and complexity is naturally an important parameter in this regard.

However, in some cases it is difficult to apply this approach in practice as the inclusion of sustainability-related objectives adds a whole new dimension of product features often barring the manufacturers from clustering otherwise similar financial products.

This applies, especially, but not exclusively, to financial products such as shares and derivatives.

Shares
Due to the introduction of sustainability-related objectives in the clustering approach, shares that otherwise could be clustered to-

gether with no regard to the sustainability related objectives because of their otherwise similar features and characteristics may now not be clustered as these shares can have very different impacts on sustainability factors. To give an example for distributors delivering investment advisory services on individual securities such as bonds and shares, this will complicate the product governance disproportionally. If such a distributor should further divide clusters of for instance small, mid and large cap and regionally/sector defined clusters further by their impact on sustainability factors this will disproportionally complicate the product governance process. There is therefore a risk of a shrinking product supply for investors.

Furthermore, there is a large lack of sustainability data for many shares. This makes it even more difficult to cluster shares correctly on the basis of sustainability features and leaves the manufacturers and distributors with a risk of making unintended errors in the process due to the missing data. This is neither to the benefit of investors nor investment firms.

Derivatives
Due to the nature of derivates being an array of various contracts with often homogenous features, they naturally fit with the clustering approach despite that they might be complex also in MiFID-terminology. ESMA should also be mindful that most OTC derivatives are used for hedging purposes and that the requirements from a product governance perspective should be proportionate to reflect that purpose. It should also be noted that OTC derivatives under PRIIPs are using general KIDs and that a requirement on an individual product level would be contrary to that set-up (assuming here that "individual" means for each trade; if that is not meant here then that should be clarified). Finance Denmark acknowledges that insufficiently comparable derivatives must be clustered separately to ensure a sufficiently granular grouping of the derivatives in order to identify a granular target market by the firms.

On the one hand, it would be very cumbersome for the manufacturers to do a target market assessment of each individual OTC-contract one by one. Clustering should be allowed for OTC-derivatives in accordance with their features.

Therefore, Finance Denmark suggests that the added wording concerning OTC-derivatives, in the last sentence of paragraph 27, is removed because the wording excludes OTC-derivatives from being clustered even though that certain groups of OTC-derivatives may have the same or comparable features and are otherwise homogenous. If the clustering of OTC-derivates is denied, it would entail a large, disproportionate amount of work for manufacturers and distributors. ESMA could risk that products that are mainly used to hedge risk for certain client segments might not be offered any more due to disproportional operational costs. Thereby these clients might not have access to instruments used for risk reduction.

In addition, hereto, the protection of the investors is already, in our view, safeguarded sufficiently by the current regulation.

Therefore, Finance Denmark suggest an alteration of the last sentence in paragraph 27 with the following wording.

"*For certain more complex products, such as certain OTC-derivatives and structured products, it is expected that a clustering approach is applied with due care and that firms should define the target market with a due level of prudence and granularity*"

Alternatively, Finance Denmark suggests that the last sentence in paragraph is deleted.

In terms of more complex products limited to the most knowledgeable and experienced customers with highly specific needs and goals, the clustering approach does not fit either as this approach is not of practical relevance to them and their specialized products. Instead, Finance Denmark would stress the importance of proportionality in this regard.

Additionally, Finance Denmark would appreciate some examples of how to group similar financial products in accordance with their sustainability-related objectives. This could possibly be done in Annex IV containing examples of good practice.

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.

Finance Denmark has no remarks to this question.

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.

Finance Denmark appreciates the clustering approach is also made available for the distributors. This improves the link between the manufacturers' identification of the target market and that of the distributors as well as streamlines the guidelines.

In our reading of the added text in paragraph 46, it is unclear whether the information provided through dataflows, such as the EMT, by the manufacturer to the distributor in ESMA's view is sufficient for the distributors' identification of the target market. Finance Denmark would, therefore, like to ask for clarification on whether the distributor is obliged to collect additional information from the manufacturer and if so examples of the nature of such data could be described in the appendix the guidelines as best practice examples.

ESMA should however be mindful of the fact that, this would mean an additional administrative burden for both the manufacturers and distributors. This, in our view, would be disproportionate as the market participants already have a great focus on identifying the target market and already allocate a lot of resources into the process.

Further, we suggest that a reference to paragraph 59, perhaps in conjunction with the reference to paragraph 60, is included in paragraph 56 to increase the cohesiveness and consistency of the guidelines.

Paragraph 46 entails the obligation for the distributor to define the target market for their products on a more concrete level than the manufacturers. In doing so, the distributor should also adopt a more granular classification consistent with the distributor's suitability or appropriateness arrangements as well as using concepts in line with these arrangements.

However, the introduction of the obligation to operate with a more granular classification than the manufacturer is, in our view, an unnecessary and disproportionate measure. Adopting a more granular classification by the distributer might be necessary in some cases and as ESMA states this might depend on features of the product, however, in other cases for simpler products the distributor should be able to use the same classification granularity as the manufacturer.

Using the same concepts as the manufacturers for the vast majority of simpler products is also a part of operationalizing the processes delivering value for money for end investors.

Increased granularity of the target market would in most cases not in practice lead to increased investor protection as it does not guarantee better matches of financial products with investors.

Finance Denmark, therefore, suggests that the wording “should adopt” in line 11 of paragraph 42 is changed to the wording” could, where relevant,”. This wording also increases the cohesiveness of the text due to existing wording of “where appropriate given the features of the products” in the sentence. This wording would ensure sufficient proportionality and flexibility for the distributor.

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.

Finance Denmark has no remarks to this question.

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.

Finance Denmark does not agree with the suggested approach with regards to “knowledge and experience”. The suggested approach on the deviation possibility does not make sense in our opinion in relation to portfolio managements agreements. In such agreements, a professional portfolio manager may buy and sell financial products on behalf of the client. This means that the relevant portfolio manager may trade financial products that may not fit the target market of the client, but which are to the benefit of the client. This may be the case for a wide range of financial instruments that serve the purpose of hedging risks, such as currency risks or interest rate risk. This is also the case for financial products that diversify the portfolio, which adds value to the clients.
One of the basic purposes of a portfolio management agreement is to equip the client with additional knowledge by proxy through the professional portfolio management in order to increase the value for the client.
Therefore, deviations from the product’s target market in relation to portfolio management agreements when it comes to “knowledge and experience” are, in our view, justifiable if they

benefit the client since they are conducted by a professional investor.
The suggested approach, in our view, limits the flexibility of the portfolio manager to the detriment of the clients and hinders them getting an optimal framework for portfolio allocation.

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.

In paragraph 72, it is stated that distributors should determine what information they need in order to draw reliable conclusions on whether financial products have been distributed to the identified target market. In order to do so, the distributors are obliged to undertake steps to gather further information on their clients than what they already have from their daily business. The guidelines emphasize that firms may need to send questionnaires to clients that have bought one or more products under non-advised services. We understand the focus of ESMA to ensure reliable data on whether products have been distributed to the identified target market. However, distributors would normally have these data available with regards to their own distribution to clients. Further, standardized data templates are available from FinDatEx (EFT template) to be used by distributors to share information with manufacturers concerning how products are distributed. We must again emphasize that investment firms have focus on operationalizing the product governance processes to increase quality of the process and the overall "value for money" for end investors. Such a measure would therefore in our opinion be disproportionate. Further, this could require the gathering of consents from the clients in order for the distributors to comply with GDPR as well as EU and national marketing legislation. This increases the administrative burden of the distributors. Therefore, in our view, the wording concerning the sending of questionnaires should be removed from the guidelines.

Finance Denmark supports the clarification in the first part of paragraph 73 of the draft guidelines stating that where a distributor no longer offers, sells or recommends a product, the distributor is no longer obliged to review the target market of that product, despite that a client may still be invested in that product. However, Finance Denmark disagrees to that a distributor should still be required to review the target market of a product where a distributor recommends to its clients to hold a product it no longer offers or sell

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.

In a strict reading of the second sentence of art. 9 of the Delegated Directive of 2021/1269 amending the Delegated Directive 2017/593, it is not necessary to define a negative target market for financial products which consider sustainability factors. This exception covers the clients' needs, characteristics as well as objectives in the identification of the potential target market.

According to paragraph 81 of the guidelines, this exception, however, only applies to a negative target market with regards to products which consider sustainability factors. Firms must, therefore, according to the guidelines, always perform a negative target market assessment with respect to the five remaining target market categories (client type, knowledge and experience, financial situation, risk tolerance and objectives and needs) for products that consider sustainability factors.

In a strict reading, the guidelines limit the scope of the exception in art. 9 of the Delegated Directive of 2021/1269 and thereby simultaneously expands the scope of the provision.

Even though, Finance Denmark sympathizes with this approach it is, in our view, a cause of legal uncertainty for market participants.

Further, it is unclear to us whether firms are to identify a negative or positive target market, respectively, in relation to sustainability-related objectives for products which do not consider sustainability factors. This is further complicated by the fact that the term "products which consider sustainability factors" is not defined anywhere in legislation nor guidelines. Therefore, Finance Denmark would like to ask for further guidance on these uncertainties.

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.

Finance Denmark has no remarks to this question.

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

Finance Denmark would appreciate if examples concerning products which consider sustainability factors were to be included in the list of good practices.
Additionally, please see question 4 and 10.

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

Finance Denmark has no remarks to this question.