
Response to the ESMA Consultation Paper ESMA35-43-3114 Review of the Guidelines on MiFID II product governance requirements

7 October 2022

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME has produced this response with advisory support from Latham & Watkins LLP and Linklaters LLP. We note that the International Swaps and Derivatives Association (ISDA) is also producing a response to this consultation, with which we generally agree and support.

Please find set out below our Members' response to the questions raised in the consultation. Where responses or parts of responses are specific to a particular asset class (*e.g.*, structured products), this is highlighted in the relevant responses. Otherwise the responses set out our Members' views, generally, in relation to wholesale financial markets.

Our Members also note the fundamental principle of proportionality which underpins the product governance regime, enabling firms necessary flexibility to comply with product governance requirements in a way that is proportionate to their business model. This, in turn, ensures firms deliver appropriate product governance outcomes for clients. Our Members also note the flexibility afforded to distributors in the context of ESMA's recent Final Report on Guidelines on certain aspects of the MiFID II suitability requirements (ESMA 35-43-3172), in particular, with regard to distributors assessing clients' sustainability preferences – which is relevant to Members that are manufacturers who will interact with distributors looking for products that are suitable for and match their clients' sustainability preferences. The core principle, therefore, underlying Members' responses in this paper is that Members seek to leverage proportionality and flexibility as they currently do now in relation to integrating sustainability and ESG driven considerations into their product governance processes (and in a way that is consistent with the flexibility afforded to distributors as described above).

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.

AFME response:

Substantiating and documenting product governance choices

ESMA proposes adding new paragraph 13 of the draft guidelines clarifying that firms should substantiate and document choices made in the context of their product governance arrangements. Members note that prevailing market practices have made use of the principle of proportionality as principally provided for in Recital 18 of Commission Delegated Directive (EU) 2017/593 especially in respect of the complexity of a product and the categorisation of the investor, set out by the existing guidelines and now further specified in paragraph 24 of the consulted draft Guidelines.

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We appreciate the opportunity to remind ESMA of the central importance of the proportionality principle for firms and the resulting flexibility afforded to firms and the necessity of its effective application in order to make the product governance rules appropriate across the broad range of asset classes, and in relation to different client types, that fall within MiFID II. A key example is the substantive industry work performed in respect of certain asset classes at the time of MiFID II implementation to achieve this goal. In the context of equity capital markets, the following comprehensive framework was produced: [AFME ECM Protocol for ordinary shares](#). Our Members' view is that any dilution of the proportionality principle (for example, in relation to the varying granularity of the target market assessment based on the complexity of the financial instrument and categorisation and sophistication of the client) would serve to impose an additional compliance burden on both manufacturers and distributors, with no demonstrable investor protection benefit.

ESMA will have noted that the above referenced example takes a proportionate approach to target market disclosure having substantiated the proportionality rationale for doing so. Members have considered the proposed guidance and do not see a need for any material change in the above referenced protocol at this time, in light of the proposed enhancements to the ESMA guidelines discussed at Question 1. Members view the exemption in Article 16(a) (as included by **MiFID II Amending Directive** (EU) 2021/338) in relation to "bonds with no embedded derivative other than a make-whole clause" as a helpful clarification for the capital markets as to ESMA's view on the treatment of the product governance regime in the context of non-complex instruments and this further supports the proportionality analysis (in the above referenced protocol) with respect to other non-complex instruments such as shares.

The concept of limiting requirements in relation to less complex products or in cases in which only more sophisticated investors are impacted is also generally in line with other regulations, including: (i) Regulation (EU) No. 1286/2014 (**PRIIPs Regulation**) according to which no key information document is required in relation to certain products not being sold to retail investors, or (ii) Regulation (EU) 2017/1129 (**Prospectus Regulation**) and Delegated Regulation (EU) 2019/980 according to which the extent of information is limited in case of wholesale-issuances compared to retail-issuances.

On the basis of the principle of proportionality, our Members have taken the view that it is appropriate to merge or simplify certain criteria of the target market determination. Therefore, we suggest including an exemption to the clarification added in paragraph 16 of the Guidelines (page 27) along the lines of "[...] unless the complexity of the product and/or the targeted potential investors justify a simplified target market determination".

Members welcome the clarification made in paragraph 19a. of the Guidelines as to the categorisation of different types of potential investors which enhances legal certainty. More specifically, Members support the approach taken by ESMA to differentiate between different types of clients along the lines of the MiFID II client categorisation. This is consistent with the existing market practice.

Exemptions

Members are supportive of the confirmation in the Guidelines that bonds with no embedded derivative other than a make-whole clause and financial instruments that are marketed or distributed exclusively to eligible counterparties are not within scope of the MiFID II product governance rules.

Cost structure and scenario analysis

ESMA proposes adding new paragraph 14 of the draft guidelines clarifying that, when determining the target market, firms should take into account the results of the scenario and charging structure analyses undertaken for the relevant product.

Members note that manufacturers will consider scenario analysis and the charging structure as part of determining the target market and their internal product approval processes, applying the principle of proportionality. Running and disclosing scenario analysis, correlates with the relevant application of proportionality and Members have controls in place to determine, based on the complexity of the product and the sophistication and categorisation of the client, whether individualised, point of sale scenario analysis is relevant.

Cross reference to risk indicators

Please note that the sections below relate to an analysis for structured products:

ESMA raised an observation that firms may be limiting the consideration of the target market's risk tolerance to a reference to a summary risk indicator provided in the context of other EU regulations (e.g. PRIIPs KID regulation). Members would like to highlight in this context that, consistent with a multi-sector initiative to operationalise a consistent target market disclosure across asset classes on a pan-EU basis, manufacturers of many MiFID financial instruments (including, structured products, structured deposits, insurance based investment products and certain funds) adopted the [European MiFID Template \(EMT\)](#). This template necessitates manufacturers communicating the target market data to distributors in a prescribed format. For 'risk tolerance', the template prescribes including a reference to the SRI (PRIIPs) / SRRI (UCITS) or otherwise specifying 'low', 'medium' or 'high'.

EMT – Risk tolerances

| | | | | |
|--|-----------------|---------------------------|----|---|
| 1. PRIIPS Methodology | SRI | 1-7 Empty | or | If PRIIPS KID is available. German distributors will use only this Risk Tolerance item |
| 2. UCITS Methodology | SRRI | 1-7 Empty | or | For funds |
| 3. Internal Methodology For Non-PRIIPS And Non-UCITS | Low/medium/high | (L or M or H) or Empty | | For NON PRIIPS and NON UCITS. |
| 4. For Non-PRIIPS and Non-UCITS Spain | Spanish SRI | 1-6 Empty | or | For Spanish local NON PRIIPS and NON UCITS products. |
| 5. Not For Investors With The Lowest Risk Tolerance Germany | Yes or Neutral | Y / Neutral | | Orden ECC/2316/2015, de 4 de noviembre, relativa a las obligaciones de información y clasificación de productos financieros |

Use of the SRI / SRRI as a measure of the risk tolerance of the target market ensures that information on the risk profile of the instrument is identified and communicated consistently across the manufacturers, distributors (via the EMT) and investors (via the KID / KIID). Therefore, it is our Members' view that, where an SRI / SRRI is available, it should continue to be used for the purpose of the determination of the risk tolerance of the target market.

Furthermore, Members wish to highlight that possible additional risks which are not contemplated by the SRI / SRRI calculation methodologies are currently already taken into account by manufacturers for the purpose of determining the target market of the instruments and may affect other target market categories (e.g. where an instrument that provides for full capital protection is issued in a currency other than the one of the Member State where it is distributed, manufacturers may include clients who are not able to bear any capital loss in the neutral/negative target market instead of in the positive target market).

Use of the abovementioned EMT template as a communication method between manufacturers and distributors should, therefore, not be viewed as indicative that firms view the SRI / SRRI alone as a conclusive basis on which to *assess* and *disclose* risk tolerance within the target market.

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.

AFME response:

Background

Please refer to the Annex for the background relevant to our members' response to this question.

Subject to our views in the "*Analysis*" section below, members generally agree with the principle of aligning the definition of "sustainability related objectives" with the definition of "sustainability preferences" according to Article 2(7) of the **MiFID II Delegated Regulation** (EU) 2017/565 (as amended by Delegated Regulation (EU) 2021/1253) as these categories will have to be considered by a distributor investment firm providing investment advice or portfolio management services when assessing the suitability of a financial instrument for a particular client according to Art. 54 (2) MiFID II Delegated Regulation 2017/565.

However, we note and agree with ESMA's assessment that while alignment between the product governance and the suitability assessments is to be expected in certain cases, it is only an option (rather than mandatory) and we view this as consistent with the principle of proportionality (and the necessary flexibility that it affords). For example, in the context of structured products, for those products to which categories 1-3 can be applied, linking the sustainability objectives with the sustainability preferences will likely be of interest of those distributors to whom the MiFID II suitability requirements apply. In particular, it may not be appropriate or proportionate, for products which are not sold via investment advice / portfolio management, to link the sustainability objectives of the products to Categories 1-3 (as set out in the Annex). Therefore, in appropriate cases, we agree with the possibility of using alternative methodologies to the ones prescribed for "sustainability preferences" in categories 1-3, for products which focus on either environmental, social or governance criteria, or combinations of them.

- This is relevant because, despite the suitability requirements not being directly applicable to manufacturers, those requirements are applicable to certain distributors (i.e., those who provide

investment advice or portfolio management services to their clients under MiFID II and including assessment of clients' sustainability preferences) and this may have, in practice, an "upstream impact" on manufacturers. Such an alignment of the criteria used in the determination of the target market by the manufacturer and the information a distributor is required to ask the manufacturer for (as a result of the distributor's suitability assessment obligations) helps to match a client's preferences with a product's identified target market and therefore supports the suitability assessment by the distributor. In view of the upstream impact on manufacturers, Members welcome that distributors are not obliged to request sustainability preferences in all cases (i.e. this obligation relates specifically to a suitability assessment under an advised / discretionary managed channel) (Article 2(7) Delegated Regulation (EU) 2017/565 (as amended by Delegated Regulation (EU) 2021/1253).

- The draft Guideline, in turn, makes clear that manufacturers have discretion not to specify a sustainability-related objective (para 20 of the draft Guidelines: "... *when identifying sustainability-related objectives, firms **may** specify, where relevant, the following aspects*" (emphasis added)). This preserves the concept of proportionality for manufacturers, in particular with respect to the sale of non-complex instruments and / or sales into wholesale markets. This also gives manufacturers welcome, and necessary, flexibility to consider sustainability related objectives, other than sustainability preferences, which may be more appropriate, e.g. for products that do not expressly consider alignment with the EU Taxonomy.
- Based on the draft guidelines, members may take the view that manufacturers could assess sustainability related-objectives for the purposes of the target market determination with respect to, for example, products that do not consider the SFDR or the EU Taxonomy alignment test (and therefore do not fall within Categories 1 to 3 as set out in the Annex). Therefore, for those products, we support the possible use of an alternative category (where the product has a focus on either environmental, social or governance criteria or a combination of them).

Analysis

Members have the following feedback on the practicalities associated with selecting one of the three Categories set out in the Background section in the Annex below in order to assign a MiFID financial instrument with a positive target market with respect to sustainability related-objectives:

- a. Members note that MiFID II Delegated Regulation (EU) 2021/1253 on sustainability preferences applied as of 2 August 2022, whereas MiFID II Delegated Regulation (EU) 2021/1269 on sustainability factors will only apply as of 22 November 2022. This could force certain distributors to determine the sustainability preferences of the target market without any guidance by the respective manufacturer.
- b. In addition, it seems unclear in the current reporting environment whether the information required in order to determine the sustainability preferences can be obtained. Most market participants are currently not able to determine with precision an exact percentage for, e.g. "environmentally sustainable investments" within the meaning of Regulation (EU) 2020/852 or "sustainable investments" within the meaning of Regulation (EU) 2019/2088 (neither at an entity level nor for particular instruments like use-of-proceeds green bonds), but at best could provide minimum quotas (see Q3 below). The currently planned **Corporate Sustainability Reporting Directive** will likely improve the level of available data, however, it is only due to apply in 2024. Manufacturers, not having obtained the respective issuer's confirmations, will likely not be willing to expose themselves and may determine that the investment cannot be regarded as sustainable which would naturally have a negative impact on the availability of sustainable products. Therefore, whilst there are limitations on the availability of data required to determine sustainability-related objectives along the line of the criteria determined in Article 2(7) of the

MiFID II Delegated Regulation (EU) 2017/565 (as amended by Delegated Regulation (EU) 2021/1253), there seems to be a risk that products matching an investor's sustainability preferences as defined therein will be limited.

- c. Likewise, it appears challenging for issuers to evidence compliance with the “minimum safeguards” under Article 18(1) of Regulation 2020/852 that are required with respect to the first category of “sustainability preferences” under Article 2(7)(a) of the Delegated Regulation (EU) 2017/565 (as amended by Delegated Regulation (EU) 2021/1253). In this context, we note and support the efforts of the Platform on Sustainable Finance to clearly delineate the meaning of the term “minimum safeguards” under Article 18(1) of Regulation 2020/852 by defining “safeguards” as protections against potential harm as opposed to positive impacts on sustainable development. As the Platform on Sustainable Finance pointed out in its draft report (p. 7) the minimum safeguards are closely linked to the forthcoming requirements for companies under the future Directive on **Corporate Sustainability Due Diligence**. The latter is still in draft form and companies are still in train of working out internal processes and procedures to ensure and document with adequate certainty the alignment of their business with these requirements. While both the specific content of these requirements and their entry into force are pending, a proportionate approach from ESMA to this effect seems required.
- d. In order to leverage the terminology or data sets deriving from SFDR and / or the EU Taxonomy, manufacturers would be reliant on that data being available in the context of the MiFID financial instrument, either from its issuer or in the context of any underlying to which an investment in the product is demonstrably linked. This is important both at product approval stage, in order to provide adequate information about the sustainability related objectives, within the target market and any accompanying product literature, but also in the context of the periodic review obligations, to ensure that the features of the instrument remain consistent with the sustainability related-objectives. Taking into account the current landscape for ESG reporting, this would limit the below mentioned Categories 1 - 3 (see the Annex) to the following:
 - Issuers reporting under the EU Taxonomy or which make disclosures relating to sustainability considerations in line with SFDR, or linked with specific sustainability KPIs (i.e. Principal Adverse Impacts)
 - An underlying investment pool of funds which is compliant with EU Taxonomy or which makes disclosures of their proportion of SFDR sustainable investments (for either Article 8 or Article 9 financial products).

Members also note that based on the current draft Guidelines, manufacturers may be limited in their application of the three sustainability preferences aligned categories to the currently limited pool of financial instruments with sustainability features (as recognised at paragraph 34 of ESMA's Consultation Paper on Guidelines on certain aspects of the MiFID II suitability requirements¹).

In addition, noting the perceived limitations of Categories 1 – 3, as summarised above, Members are of the view that when manufacturers and distributors are determining whether a financial instrument has a “focus” on an E, S or G factor, noting that many corporate issuers will make statements on their commitment to sustainability factors in varying manners on their website, a MiFID investment firm, which performs the role of manufacturer on a capital market transaction would not adopt a positive sustainability factor target market

¹ https://www.esma.europa.eu/sites/default/files/library/esma35-43-2998_consultation_paper_on_review_mifid_ii_guidelines_on_suitability.pdf

simply because the issuer otherwise expressed a focus on E, S and / or G. Such an outcome would be highly disproportionate since it would place a liability on the manufacturing syndicate banks for the sustainability performance of an issuer in circumstances where the bank has no control on how the issuer seeks to deploy its finance.

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.

AFME response:

We note that paragraph 26 of the Consultation Paper provides that *“Even though the term ‘minimum proportion’ is derived from the SFDR and the Taxonomy Regulation, ESMA notes that in the MiFID context, it should be read in a broad sense (i.e. possibly also applying to products with sustainability factors that are not in scope of the SFDR and/or the Taxonomy Regulation)”*.

In addition, in our view, calculating a “minimum proportion” in the context of an issuance of shares or bonds does not work well, and is unlikely to be helpful to a distributor providing MiFID investment advice or portfolio managers who is obliged to obtain “sustainability preferences” from the client (and match the advice / portfolio management with those preferences if possible. The definition of sustainability preferences uses the concept of “minimum proportion” but this term seems to be used in reference to the composition of sustainable investments in portfolios that the distributor manages or advises on.

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.

New paragraph 27 of the draft guidelines provides that “for certain more complex products, such as certain OTC derivatives or structured products, it is expected that a clustering approach will not be appropriate and that firms should define the target market at the level of the individual product”. In this respect, Members note that substantive work has been done by manufacturers in the last years to build clusters of structured products having like-for-like characteristics which are assigned a similar target market. Such clustering work has been conducted taking into account the features of those products, for example, the level of complexity, risks, underlying, level of capital protection, duration etc. of the products and resulted in very granular categories which are working well and the functioning of which is constantly assessed in the context of the annual reviews of the financial instruments performed by the manufacturers. Furthermore, where a manufacturer decides to issue a new typology of structured product whose characteristics may, in abstract, fall into one of the already established clusters, manufacturers’ internal committees determine whether products of the new typology can actually be assigned the target market of the cluster or will require an additional cluster to be defined.

In light of the above, Members ask that ESMA reconsiders the wording of the proposed new guideline above by erasing reference to structured products or limiting the circumstances where the clustering approach is not expected to be appropriate only in cases of certain structured products (in line with wording used for OTC derivatives).

In addition, in our view paragraph 28 of the draft guidelines proposes an excessive granularity of key factors to be considered when clustering products, which make it unlikely that parties will be able to distinguish between different clusters of products based on all of the key factors listed in that paragraph, especially considering that there aren’t that many different sub-types of clients. We therefore deem necessary to amend

the paragraph to clarify that the proposed list of key factors is exemplary and that manufacturers must define which are relevant in order to identify different clusters of products.

For OTC derivatives

To determine the target markets for OTC derivatives, we consider that a distinction needs to be made between standardised OTC derivatives (which are fairly generic products) and "case-by-case" derivatives designed to meet the needs of a particular client.

For standardised OTC derivatives, i.e. those with common characteristics (type of underlying instrument, currency of derivative, par value, barrier, etc.), a clustering approach can be suitable. However, for "bespoke" OTC derivatives, which by their nature are unique products intended for a unique transaction, as set out by ESMA in its Guidelines, the target market defined is considered as the client having ordered the product (§24 of ESMA Guidelines on product governance ESMA35-43-620 dated 2 June 2017).

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.

No response.

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.

AFME response:

Members agree with ESMA's view that distributors may base their determination of a target market on the abstract determination by the manufacturer but need to perform their own analysis in respect of the specific investor base the distributor is facing. The purpose of the target market determination of protecting potential investors at every stage of the distribution process can only be met if the person selling the product to the (end) investor considers (in addition to the suitability and appropriateness test) such specific investor. This naturally cannot be provided for by the manufacturer as there is no interaction with the (end) investor.

Members note that it will generally not be appropriate or necessary for manufacturers to share internal governance documents relating to scenario analysis or charging structure analysis with distributors. Manufacturers have separate obligations to include all information relevant to a product in the relevant product literature and offering materials. Manufacturers may provide distributors with summary materials on their product governance process so the distributor can understand the basis on which decisions are made. We request that ESMA make necessary clarifications to paragraph 46 of the Guidelines in this regard in order that manufacturers are afforded the necessary flexibility set out above.

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.

AFME response:

The current guidelines seem to conclude that distributors may provide execution services with the assessment of appropriateness and conduct an assessment of the actual target market which is limited to the sole categories of clients' knowledge and experience, if this is proportionate and advising the clients that the firm is not in a position to assess their full compatibility with the product (guidelines 43, 45 and 47).

However, the new proposed guideline 56 seems to indicate that firms cannot sell, via non-advised sales, products for which the manufacturer/distributor identified a negative target market. This approach appears to imply that firms must always obtain information from the investor about all target market categories and always perform a suitability assessment if they wish to distribute products having more complex characteristics that may imply the identification of a negative target market.

Members therefore ask ESMA to amend the wording of the new proposed guideline 56 to contemplate that, under the principle of proportionality, such conclusions do not apply to the distribution (on the primary and secondary market) of products (including complex products) addressed to professional clients / wholesale clients whose need of protection is structurally lower than the one afforded by MiFID to retail clients. The Members' view is that the conclusions above should also not apply in case of sale of products (including complex products) to retail clients on the secondary market, where investments are usually requested by investors themselves and not solicited in any way by the firm.

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.

AFME response:

Members do not fully support the suggested approach on the deviation from the negative target market by distributors providing investment advice under a portfolio approach or portfolio management for diversification and hedging purposes.

With respect to the diversification needs of investors, Members note that there are different approaches in the market as to whether distributors deviate from all target market categories (other than client type and knowledge and experience) or just one/some of them (e.g., risk tolerance); noting, however, that responsibility for any such deviation sits with the distributors and not the manufacturers.

In the Members' view, all target market categories (other than client type and knowledge and experience) may be deviated from by distributors who perform a suitability assessment (with portfolio approach). This position is also substantiated by the fact that many distributor firms have also established thresholds in the context of their suitability model to ensure that any deviation does not expose the client to higher risks than those that have been agreed in the strategy (e.g. concentration limits on risky products, limit for products with long duration, limit for product without capital protection etc.). For portfolio management, such deviations should not be limited to “rare occurrences”.

In addition, for investment advice, Members consider that the current deviation possibility from the negative target market for ‘knowledge and experience’ should be preserved given that: (i) the client is informed that the financial instrument is in the negative target market; and (ii) the financial advisor should provide the client with the missing ‘knowledge’ on the specific financial instrument during the advisory process.

While Members agree that, for investment advice, the target market check should in principle be done at financial instrument level (keeping the deviation possibility for diversification or hedging purposes), they recommend however to make an exception to this principle for portfolio management services, where deviation should not be measured, and should not be reported, at instrument level, but rather at strategy level

(given that the agreed service and strategy are what the client is interested in). This is because, in a discretionary management scenario, clients subscribe to one of several strategies (e.g. “Balanced EUR Strategy”) rather than to specific financial instruments or issuers. These strategies are in nature identical to a multi-asset class fund, just wrapped differently (segregated account with multiple ISIN vs one distinct ISIN (the fund) with multiple ISINs within). Each strategy typically encompasses thousands of clients and contains dozens of different financial instruments. It is therefore impossible, in practice, to perform a look through and check every target market dimension for each of the thousands of clients against all the different products included in the strategy. Limiting the investment universe due to instrument level target market restrictions (and solely allowing exceptions on rare circumstances) leads to a disadvantage of risk/performance ratio for the retail client. More specifically, clients with lower risk profiles will no longer be able to sufficiently access all asset classes required for optimal diversification. As a consequence, the portfolio management service will be put at a competitive disadvantage compared to multi-asset class funds, which cannot be the intention of EU legislators.

The better approach is to assign a target market check at the strategy level. This is not only practically feasible and more accurately reflects the fact that such strategies are similar to mutual funds but also reflects how clients view these arrangements; in selecting a discretionary mandate, the client delegates the portfolio construction and maintenance to the firm and is only interested in the strategy’s objective (as opposed to the underlying financial instruments). Moreover, this approach with strategy level checks for discretionary mandate is aligned with the PRIIPs approach whereby clients are not provided with a PRIIPs KID for each transaction initiated by the portfolio manager. Therefore, only deviations from one or more of the target market categories at strategy level should be reported to the client.

Finally, for discretionary mandates, Members note that ‘knowledge and experience’ is never breached since, under the European MiFID Template, clients under a discretionary mandate are considered and classified as ‘Advanced Investors’ from a knowledge and experience attribute perspective. Therefore, for those clients, financial instruments will never be a negative target market for knowledge and experience.

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.

AFME response:

Members welcome the clarification that distributors have the responsibility to provide relevant information to manufacturers to support manufacturers’ product reviews. Approaching all distributors in relation to each product under review would incur unreasonably high costs, in particular, considering that a manufacturer is not aware which distributor in a distribution chain may be able to provide relevant information on the specific financial instrument. The clarification in paragraph 70 of the Guidelines is therefore appreciated.

The Members’ view is that the principle of proportionality set out in guideline 70 with regard to product information (i.e., that information provided by distributors should be proportionate and therefore can be in aggregated form and does not need to be on an instrument by instrument or sale by sale basis) is equally applicable to manufacturers. More specifically:

- Where, based on the determination by the manufacturer, the product is no longer to be distributed as part of the initial distribution/subscription period (“primary market”) and only available for trading by the investors on the secondary market, the manufacturer, like the distributor, should no longer be required to

review the target market². An indication of the distribution phase as determined by the manufacturer could, for example be drawn from the period specified by the issuer or the person responsible for the drawing up of a prospectus (which may be the manufacturer) for the permitted use of a prospectus for a resale or final placement of securities through financial intermediaries according to Article 5(1) sub-para. 2 Regulation 2017/1129 (**Prospectus Regulation**).

- Circumstances that do not result from characteristics of the specific kind of product but rather from the economic situation or actions of the issuer should not be part of the product review as far as investors are sufficiently protected by the means of transparency requirements applicable to issuers in the secondary market, i.e. the regular financial reporting under the Transparency Directive and the obligations under the so-called “ad hoc” publicity regime according to Art. 17 Market Abuse Regulation. A duplication of these reporting requirements appears to be contrary to the proportionality principle.
- Where the structures of those high volume and commonly traded structured products are well understood by the target market, the manufacturers should be allowed to apply the principle of proportionality to the periodic review of these products. Usually, products that share common features are assessed and reviewed in a cluster because the designed structures are mature and stable. The special circumstances affecting each security shall be dealt with when such circumstance arises rather than at a fixed time periodically, e.g. ad hoc events and underlying/securities related adjustment are communicated with the investors in accordance with the terms and conditions.

Q10: Do you agree with the suggested approach on the negative target market assessment in

AFME response:

Members agree with the suggested approach as sustainable products therewith remain available which is in line with the general EU focus on sustainable products. Even in case an investor does not express sustainability objectives or preferences, it is hard to imagine that a sustainable product collides with the investor’s objectives or 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.

AFME response:

Members welcome the clarification in paragraph 89 of the Guidelines that the target market should be related to the anticipated potential end client and not necessarily the investor the manufacturer is facing.

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

We note that these are new proposals and therefore associated practices will be nascent and evolve over time, but any good practices should be consistent with the principle of proportionality.

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

No response.

ANNEX

Background to response to question 2

Please find below what we refer to as “Categories 1-3”.

1) The minimum proportion³ of the product that is invested in environmentally sustainable investments as defined in Article 2(1) EU Taxonomy Regulation.

In order to meet this limb, the MiFID financial instrument must commit to a minimum proportion of taxonomy alignment. As defined under the EU Taxonomy Regulation, an economic activity is “environmentally sustainable” and therefore EU Taxonomy aligned if it:

- contributes substantially to at least one of the six environmental objectives specified in the EU Taxonomy Regulation:
 - climate change mitigation;
 - climate change adaptation;
 - sustainable use and protection of water and marine resources;
 - transition to a circular economy;
 - pollution prevention and control; and
 - protection and restoration of biodiversity and ecosystems;
- does not cause significant harm to the other environmental objectives specified;
- is aligned with the OECD Guidelines for Multinational Enterprises and UN Guiding Principles on Business and Human Rights, including the principles and rights set out in the eight fundamental conventions identified in the Declaration of the International Labour Organisation on Fundamental Principles and Rights at Work and the International Bill of Human Rights; and
- complies with the Taxonomy performance criteria (technical screening criteria).

2) The minimum proportion of the product that is invested in sustainable investments as defined in Article 2(17) SFDR

In order to meet this limb, the MiFID financial instrument must commit to invest in a minimum proportion of investments that qualify as “sustainable investments” under the SFDR ‘sustainable investment’ test. This test is met where an investment:

- contributes to an environmental or social objective;

³ There is guidance on how to calculate the “minimum proportion” of taxonomy-aligned investments but this doesn’t prescribe what the minimum should be. The ESMA CP specifies at FN 13 “The concept of “minimum proportion” does not apply to financial instruments for which it is not practically possible to define such minimum proportion (for instance bonds or shares, etc.). These types of products could refer to the actual proportion instead of the minimum one.”

- does not significantly harm any environmental or social objective – this test is based on the principal adverse sustainability indicators;
- are aligned with the OECD Guidelines for Multinational Enterprises and UN Guiding Principles on Business and Human Rights, including the principles and rights set out in the eight fundamental conventions identified in the Declaration of the International Labour Organisation on Fundamental Principles and Rights at Work and the International Bill of Human Rights; and
- only invest in companies / issuers with good governance practices in relation to sound management structures, employee relations, remuneration of staff and tax compliance.

3) Which principal adverse impacts (PAI) on sustainability factors are considered by the product, including quantitative or qualitative criteria demonstrating that consideration. Firms could use the categories presented in the SFDR RTS (instead of an approach based on each PAI indicator) such as “emissions”, “energy performance”, “water & waste”, etc.

In order to meet this limb, the MiFID financial instrument must commit to consider principal adverse impacts on sustainability factors, for instance based on one or more of the following categories:

- Greenhouse gas emissions;
- Carbon footprint;
- Greenhouse gas intensity of investee companies;
- Exposure to companies active in the fossil fuel sector;
- Share of non-renewable energy consumption and production;
- Energy consumption intensity per high impact climate sector;
- Activities negatively affecting biodiversity sensitive areas;
- Emissions to water;
- Hazardous waste and radioactive waste ratio;
- Violations of UN Global Compact principles and Organisation for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises;
- Lack of processes and compliance mechanisms to monitor compliance with UN Global Compact principles and OECD Guidelines for Multinational Enterprises;
- Unadjusted gender pay gap;
- Board gender diversity; and
- Exposure to controversial weapons (anti-personnel mines, cluster munitions, chemical weapons and biological weapons).
- GHG intensity⁴
- Investee countries subject to social violations⁵
- Exposure to fossil fuels through real estate assets⁶
- Exposure to energy-inefficient real estate assets⁷

⁴ Indicator applicable to investments in sovereigns and supranationals

⁵ Indicator applicable to investments in sovereigns and supranationals

⁶ Indicator applicable to investments in real estate assets

⁷ Indicator applicable to investments in real estate assets

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