

# Febelfin position on ESMA's consultation paper "Review of the Guidelines on MiFID II product governance requirements"

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.

## **I. Issue of the accessibility of bonds to retail clients**

With regard to 9., 10., 18. and 19. while we acknowledge the two exemptions from the product governance requirements introduced in the MiFID II Amending Directive<sup>1</sup> and reflected in the ESMA guidelines, we observe that most bonds issued by corporate companies ('**corporate bonds**') remain un-accessible to clients classified as Retail under MiFID (**Retail**). This is due to three key reasons:

1. Certain issuers continue to exclude Retail from the target market (TM) to avoid the risk of falling into PRIIPS<sup>2</sup> (see A below);
2. Ambiguities remain regarding the manufacturer and its role in the secondary market (see B below); and
3. Certain standard selling restrictions may be considered unfair for Retail investors by certain national regulators (see C below).
4. This creates inconsistency issues across products (see D)

As stated by ESMA in a recent paper on Retail Risk Indicators, "*if consumers are unable to access a range of investment products, they may be unable to diversify their portfolio optimally*". Bonds represent an essential part of a well-diversified portfolio. We believe that Retail investors would benefit from directly accessing corporate bonds for several reasons detailed under (E) below (incl. diversification and ESG preferences).

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<sup>1</sup> i) where a firm provides an investment service relating to bonds with no other embedded derivative than a make-whole clause; and ii) where the financial instruments are marketed or distributed exclusively to eligible counterparties (ECPs).

<sup>2</sup> MiFID II Amending Directive introduced the exemption from the product governance requirements where a firm provides an investment service relating to bonds with no other embedded derivative than a make-whole clause. This stands in line with the efforts for the exclusion of such bonds from the scope of application of the PRIIPs Regulation by the ESMA in the [Joint ESA Supervisory Statement](#) (published on 24/10/2019)



The EU has been promoting capital-market based finance for many years. Removing the above hurdles would contribute to this objective. This may be facilitated by the proportionality principle linked to product governance (F).

**ESMA could remove or lower these barriers by incorporating the following aspects in its guidelines (or Q&A):**

- **Clarify the role of the manufacturer (see A and B below) with the aim to enable more flexibility for distributors when defining the TM of bonds in the secondary market, so that they are allowed to include Retail in the TM – when they believe that the instrument is consistent with the needs of Retail investors – even if Retail investors were not in the positive TM defined in the primary market. This would also address the inconsistency issue existing due to the inaccessibility of most bonds to Retail investors (see C) and allow Retail investors to benefit from the advantages of this type of product (see D).**

**A. MISALIGNED INTERESTS**

- Issuers are not dependent on funding from Retail investors, and generally do not see a lot of value in making their bonds accessible to Retail. Therefore, they prefer to avoid the burden of PRIIPs (or the risk of their bond falling under PRIIPs) by not including Retail in the positive TM or including Retail in the negative TM – even when bonds have no specific features that would justify such an exclusion. In doing so, the focus is not the end investor but the issuer.
- Instead, distributors are in a better position to define the TM with the end investor in mind. Therefore, we believe that distributors should be allowed to include Retail in the TM if there is no particular reason linked to the instrument which would make it incompatible with Retail investors.
- However, ESMA guidelines on MiFID II product governance requirements from 05/02/2018 restrict the possibility to do so as they seem to indicate that a distributor can only restrict a manufacturer's TM and not widen it :
  - *ESMA guideline 35: "As the manufacturer has to specify the potential target market based on its theoretical knowledge and experience with a similar product, it will determine the product's target market without specific knowledge of individual clients. Therefore, the manufacturer's assessment will be conducted with a more general view of how the features/nature of a product would be compatible for certain types of investors, based on their knowledge of the financial markets and their past experience with similar products. In this way, **a set of boundaries is introduced on a more abstract level**"*
  - *ESMA guideline 38: "**When refining the manufacturer's target market, the distributor should not deviate from the fundamental decisions made therein. However, distributors cannot just rely on the manufacturer's target market without considering how the target market defined by the manufacturer would fit to their client base. For that purpose, distributors should implement and maintain a dedicated process, which needs to be run in all cases. This process is subject to proportionality, i.e. the scrutiny and – if necessary – the refinement of the manufacturers target market***



*by the distributor should be more intensive for more complex products and could be less intensive in case of simpler, more common products. **If, as a result of the process, the distributor comes to the conclusion that the target market of the manufacturer does not need to be refined, the distributor may use the manufacturer's target market as it is.***

- ESMA guideline 39: *“Usually, the target market assessment of the distributor will occur after the manufacturer has communicated its target market to him. However, it is possible that manufacturer and distributor could define both the manufacturer's target market and the distributor's target market, including any review and refinement process, at the same time. This could, for example, occur where the manufacturer and the distributor jointly develop a common target market standard for the products they usually exchange. Both the manufacturer and the distributor retain their responsibility for their obligations to identify a target market as described in MiFID II and the MiFID II Delegated Directive and further specified in these guidelines to identify a target market. A manufacturer has still to take reasonable steps to ensure that products are distributed to the identified target market and **a distributor has to ensure that products are offered or recommended only when this is in the interest of clients.**”*
- ESMA guideline 42: *“Where the manufacturer has identified a target market for simpler, more common products the distributor's target market identification does not necessarily have to result in a **refinement of the manufacturer's target market.**”*
- While manufacturers may have a tendency to define the TM in a manner that is too wide for certain products (thus justifying the need for distributors to narrow the TM), the opposite is true in the case for bonds. This could justify **a differentiated approach for bonds.**

## B. UNCLEAR NOTION OF MANUFACTURER FOR BONDS IN THE SECONDARY MARKET

- The manufacturer under MiFID is an investment firm. However, most corporate bond issuers are not investment firms.
  - Recital 15 of the MiFID II EU Delegated Directive: *“In order to avoid and reduce from an early stage potential risks of failure to comply with investor protection rules, investment firms manufacturing and distributing financial instruments should comply with product governance requirements. For the purpose of product governance requirements, investment firms that create, develop, issue and/or design financial instruments, including **when advising corporate issuers on the launch of new financial instruments, should be considered as manufacturers** while investment firms that offer or sell financial instrument and services to clients should be considered distributors.”*
  - Art 9(8) of the MiFID II EU Delegated Directive: *“Member States shall require investment firms, where they collaborate, including with entities which are not authorised and supervised in accordance with Directive 2014/65/EU or third-country firms, to create, develop, issue and/or design a product, to **outline their mutual responsibilities in a written agreement.**”*



- Art 9(8) of the MiFID II EU Delegated Directive states the need to *“identify at a sufficiently granular level the **potential target market for each financial instrument** and specify the type(s) of client for whose needs, characteristics and objectives the financial instrument is compatible. As part of this process, the firm shall identify any group(s) of clients for whose needs, characteristics and objectives the financial instrument is not compatible. Where investment firms collaborate to manufacture a financial instrument, only one target market needs to be identified.”*
- Art. 9(14) of the MiFID II EU Delegated Directive: *“Member States shall require investment firms to **review the financial instruments they manufacture on a regular basis**, taking into account any event that could materially affect the potential risk to the identified target market. Investment firms shall consider if the financial instrument remains consistent with the needs, characteristics and objectives of the target market and if it is being distributed to the target market, or is reaching clients for whose needs, characteristics and objectives the financial instrument is not compatible.”*
- Art. 10(9) of the MiFID II EU Delegated Directive requires *“**distributors [to] provide manufacturers with information** on sales and, where appropriate, information on the above reviews **to support product reviews carried out by manufacturers.**”*
- While the notion of manufacturer is clear for products manufactured by investment firms (eg funds, insurance products, other packaged products), it is less so for products such as bonds where the **issuer is the decision maker and the investment firms play only an advisory role**.
- Moreover, these investment firms are only “manufacturers” for the primary market. Once a syndicate is disbanded, the bond is free to trade by all and there is no more manufacturer.
- Recital 15 indicates that the **investment firms advising on a bond issue are the manufacturers under MiFID II**. However, the **ultimate decision on TM is taken by the issuer**. In addition, while the responsibilities of the firms managing the issue could be engaged in the primary market, it seems difficult to extend these to the secondary market, in particular concerning the need to review the financial instruments (Art. 9(14)).
- Suppose a large corporate bond is sold on the secondary market to Retail investors by distributors across Europe. Should all the distributors report back to the issuer/ investment firms that have managed the new issue?
- ESMA could contribute to further convergence across Member States by clarifying that these clauses should not be viewed as unfair.

### C. INCONSISTENCY ACROSS PRODUCTS

- In general, TMs should be set narrower for more risky or more complex products.
- However, this is not the case since Retail is excluded from TM of most corporate bonds while it is included in the TM of more risky or more complex products. For example:
  - Bonds like shares are the most basic products, they are simpler than other products such as funds, insurance or structured products
  - Bonds are generally less risky than shares from the same issuer
- This situation sometimes leads to inconsistencies. Indeed, while for corporate bonds with only make-whole calls the product governance requirements do not need to be followed, these



requirements do need to be followed for even simpler plain vanilla bonds without any of those features.

- A more flexible approach for the definition of TMs of bonds in the secondary market would make the TM framework more consistent.

#### D. ADVANTAGES OF CORPORATE BONDS FOR RETAIL INVESTORS

Retail investors would benefit from directly accessing corporate bonds for several reasons

- **Enhance diversification:**
  - Holding both debt and equity enables to build more efficient portfolios in terms of risk/return. Also because of investor preferences (see next point below), a wide variety of accessible products (including debt instruments) is essential to avoid that investors have to accept lower return or higher risk.
  - Bonds provide specific risk/return characteristics. Bonds are debt instruments and represent loans made to the issuer. The main risk is a default of the issuer. In case of bankruptcy, debt holders are reimbursed before equity holders. As a result, bonds are generally less risky than shares of the same issuer. Besides the credit risk is limited in time up to the maturity of the investment – while the equity risk born by shareholders has no maturity date
- **Address specific investor preferences:**
  - A bond provides a return in the form of periodic interest payments and the return of principal at maturity. The cash flow conditions are known in advance. A bond enables to address particular needs of clients, including a regular income and payment of a large amount (the principal) at a specific date in the future where a large financial need is expected.
  - It can also address other client preferences such as ESG, tax and liquidity.
- **Avoid costs:**
  - Direct investment in bonds or shares avoids an additional layer of costs when compared to funds, insurance products or other instruments manufactured by investment firms

#### E. PRINCIPLE OF PROPORTIONALITY

- Art. 10(1) of MiFID II EU Delegated Directive: *“Member States shall require investment firms, when deciding the range of financial instruments issued by themselves or other firms and services they intend to offer or recommend to clients, to comply, in a way that is appropriate and proportionate, with the relevant requirements laid down in paragraphs 2 to 10, taking into account the nature of the financial instrument, the investment service and the target market for the product”*
- This could support the drafting of specific guidelines pertaining to bonds by ESMA.



## II. Issue of integrating the results of the scenario and charging structure analyses in the identification of the target market

We have some concerns about the application of § 14 and the reference to “relevant products”. Indeed, when identifying the target market, it seems possible to take into account the results of the scenario and charging structure analyses for structured products but not for other types of products. We therefore would suggest ESMA to clarify what it means by “relevant products”, as this notion seems very general to us.

Q2: Do you agree with the suggested approach on the identification of any sustainability-related objectives the product is compatible with? Do you believe that a different approach in the implementation of the new legislative requirements in the area of product governance should be taken? Please also state the reasons for your answer.

We understand that the ESAs have requested clarification regarding the application of the SFDR definition of “sustainable investment” to funding instruments that do not specify the use of proceeds (*List of additional SFDR queries requiring the interpretation of Union law, 9 September 2022, JC 2022 47*). Additional guidance on this topic would be much appreciated.

However, the same question could be asked regarding the concept of “principal adverse impacts” for these products. Would it therefore be possible to clarify if general funding products such as equity or debt instruments can be deemed to “consider principal adverse impacts”, and under which conditions this may be the case? Could it for instance be presumed that a share considers a principal adverse impact such as “GHG emissions”, if the investee company actively strives to limit the GHG emissions of its activities?

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.

Febelfin has no specific input regarding this question

Q4: Do you agree with the suggested guidance on complexity in relation to the target market assessment and the clustering approach? Please also state the reasons for your answer.



As mentioned under point 32., “the 2021 CSA revealed that firms tend to use significantly varying levels of granularity when clustering products for the purposes of the target market assessment, sometimes resulting in too broad clusters containing financial instruments with insufficiently comparable product features.”

ESMA writes under 33. “It is however key that firms use a sufficient level of granularity when clustering products, considering the level of complexity included in a cluster. Generally speaking, this will mean that the more complex the underlying products of a cluster become, the more granular the clustering should be.”

However, under 34. it reads “For example, where a firm manufactures/distributes a certain fixed income product, it should check whether the product satisfies the criteria for the relevant cluster for such fixed-income products (e.g. in terms of credit rating, duration, currency denomination, and so on). Such a check should be documented by firms.”

**Considering the existing major barriers preventing the access to bonds by Retail investors, we fear that guidelines 28. and 29. may give another incentive to issuers (and financial institutions advising them during the new issue process) to focus even more on the institutional and wholesale market. We would therefore suggest avoiding too prescriptive guidelines or at least clarifying that guidelines 28-29 are directed at more complex products.**

As stated by ESMA in a recent [paper on Retail Risk Indicators](#), “if consumers are unable to access a range of investment products, they may be unable to diversify their portfolio optimally”. Bonds represent an essential part of a well-diversified portfolio. We believe that Retail investors would benefit from directly accessing corporate bonds for several reasons detailed under **(point E in Q1)** above (incl. diversification and ESG preferences).

**ESMA could remove or lower these barriers by incorporating the following two aspects in its guidelines (or Q&A):**

- **Allow proportionate use of clustering approach for distributors when defining the target market of bonds in the secondary market, so that they are allowed to include Retail in the TM – when they believe that the instrument is consistent with the needs of Retail investors – even if Retail investors were not in the positive target market defined in the primary market. See rationale under (points A, B, C, E in Q1) (3) and (4) (5) above.**

**Q5: Do you agree with the suggested guidance on the assessment of the general consistency of the products and services to be offered to clients, including the distribution strategies used? Please also state the reasons for your answer.**

ESMA writes under 37. “In ESMA’s view, firms should take responsibility to ensure the general consistency of the products and services that are going to be offered to clients, and which products are to be offered under the different services.”



**As stated in our answer to Q1 and Q4, we believe that the exclusion of Retail from manufacturers' TM for many bonds at the time of the new issue leads to an inconsistency in the distributors' TM (the 'actual' TM) if distributors are not allowed to enlarge TM in the secondary market (compared to the manufacturers' TM) – assuming that the instrument is consistent with the needs of Retail investors. Moreover, as mentioned before, syndicates only determine TM for the primary market. Afterwards, the syndicate is disbanded and the bond is free to trade allowing any distributor to determine the TM on its own, of course taking into account the MiFID legislation and guidelines. Therefore, we would welcome the support of ESMA as stated before.**



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.

Draft guideline 46 states: *“When refining the manufacturer’s target market, the distributor should not deviate from the fundamental decisions made therein.”*

**As stated in our answer to Q1 and Q4, ESMA could allow more flexibility for distributors when defining the target market of bonds in the secondary market, so that they are allowed to include Retail in the TM – when they believe that the instrument is consistent with the needs of Retail investors – even if Retail investors were not in the positive target market defined in the primary market. See rationale under points A, B, C, E in Q1 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.

ESMA states under 42: *“The 2021 CSA showed that firms often limit this identification of the distribution strategy to the specification of the investment service or applicable point-of-sale regime under which the product should be distributed (e.g. advised versus non-advised sales, or the execution-only exemption). While this might be sufficient in some cases, for example where it concerns a relatively simple product with a relatively broad target market or where the firm restricts the distribution strategy for a product to advised sales only. In other cases such an approach will not be sufficient for determining a compatible distribution strategy. This would be the case, for example, when a firm considers that a relatively complex product with a relatively narrow target market can be distributed under non-advised sales. In such cases, ESMA considers that additional measures are necessary to ensure that the firm duly identifies a compatible distribution strategy that enables the product to reach the identified target market.”*

ESMA states under 43. : *“Against this backdrop, building on the requirement that the distributor should refine the manufacturer’s target market, ESMA proposes clarifying in paragraph 59 of the draft guidelines that distributors should refine the distribution strategy as proposed by the manufacturer.”*

Draft guideline 59: *“Considering the nature of the product and the investment service, distributors should refine the distribution strategy as identified by the manufacturer taking into account the characteristics of the distributor’s client base.”*



We understand that the focus is primarily complex products, but fear that this draft guideline 59 is further reinforcing the idea that manufacturer's TM are initially defined too broadly and must be narrowed by distributors – which is not the case for bonds.

**As stated in our answer to Q1 and Q4, ESMA could allow more flexibility for distributors when defining the target market of bonds in the secondary market, so that they are allowed to include Retail in the TM – when they believe that the instrument is consistent with the needs of Retail investors – even if Retail investors were not in the positive target market defined in the primary market. See rationale under points A, B, C, E in Q1 above.**

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.

ESMA states under 45.: *“Supervisory experience has shown that some firms using this deviation possibility do not apply the relevant product governance requirements, such as performing a target market assessment for the product. Moreover, some firms appear to use the deviation possibility too broadly, for example in relation to the target market categories “type of client” and “clients’ knowledge and experience”. In ESMA’s view, a deviation from these categories cannot be justified for diversification or hedging purposes. This is proposed to be clarified in paragraph 64 of the draft guidelines.”*

Draft guideline 64: *“Providing investment advice adopting a portfolio approach or portfolio management services does not exempt the firm from defining a target market for each product to be distributed and from monitoring deviations from the target market to ensure that products are only distributed outside the target market when this can be justified for diversification or hedging purposes. Moreover, a deviation from the product’s target market categories “client type” and “clients’ knowledge and experience” cannot be justified for diversification or hedging purposes.”*

**Allowing deviations in the case of bonds with regard to the target market category “type of client” could be a way for ESMA to allow more flexibility for distributors when defining the TM in the secondary market as proposed in our response to Q1 and Q4.**



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.

Draft guideline 67: *“Article 16(3) MiFID II and Articles 9 and 10 of the MiFID II Delegated Directive require manufacturers and distributors to review products on a regular basis to assess whether the product remains consistent with the needs, characteristics and objectives, including any sustainability-related objectives, of the identified target market and whether the intended distribution strategy remains appropriate.”*

Draft guideline 68: *“Firms should use both quantitative and qualitative criteria to review products, relating to the product’s characteristics (e.g. changes in the product’s risk factors, investment strategy, cost structure (e.g. level and types of costs), ...), market conditions (e.g. adverse market conditions, regulatory developments, ...) and distribution (e.g. client complaints, sales outside the target market, results from client surveys, online client trading behaviour, ...). Firms should determine the frequency and depth of product reviews while taking into account the nature of the product and, where appropriate, the service. For example, for certain simpler products distributed under the execution-only regime, product reviews can be less frequent and require less depth, and ad-hoc reviews can in such cases to a large extent be driven by client complaints and/or market events that significantly affect the product’s risk-return profile.”*

Draft guideline 70: *“To support reviews by MiFID manufacturers, distributors must provide them with information on sales and, where appropriate, any other relevant information that may be the outcome of the distributor’s own periodic review. Whenever distributors have relevant information to support reviews by MiFID manufacturers, they should proactively provide it to the manufacturer and not provide such information only at the manufacturer’s request. Furthermore, distributors should consider data and information that may give an indication that they have wrongly identified the target market for a specific product or service or that the product or service no longer meets the circumstances of the identified target market, such as where the product becomes illiquid or very volatile due to market changes. Any such information is subject to the proportionality principle and may generally be in an aggregated form and does not generally need to be on an instrument-by-instrument or sale-by-sale basis. However, instrument-specific information should be provided in cases with particular relevance for certain individual instruments (e.g. if the distributor comes to the conclusion that a target market for a specific product was wrongly determined).”*

The manufacturer under MiFID is an investment firm. However, most corporate bond issuers are not investment firms.

While the notion of manufacturer is clear for products manufactured by investment firms (eg funds, insurance products, other packaged products), it is less so for products such as bonds where the **issuer is the decision maker and the investment firms play only an advisory role in the primary market.**

Recital 15 of the MiFID II EU Delegated Directive indicates that the **investment firms advising on a bond issue are the manufacturers under MiFID II.** However, the **ultimate decision on TM is taken by the issuer.** In addition, while the responsibilities of the firms managing the issue could be engaged in



the primary market, it seems difficult to extend these to the secondary market, in particular concerning the need to review the financial instruments (Art. 9(14)).

Suppose a large corporate bond is sold to Retail investors by distributors across Europe. Should all the distributors report back to the issuer/ investment firms that have advised on the new issue?

**We would suggest ESMA to clarify that certain aspects of the guidelines 67, 68 and 70 on periodic review are not applicable to bonds (and shares) in the secondary market (e.g. exchange of information between manufacturers and distributors) for the reasons explained in our answer to Q1.**

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.

Q11: Do you agree with the suggested updates on the application of the product governance requirements in wholesale markets? Please also state the reasons for your answer.

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

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

Febelfin has no specific input regarding these questions.