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European Securities and Markets Authority

Date: 5 January 2017

Dear Sir or Madam,

RE: ESMA/2016/1436 (MiFID II product governance guidelines CP)

The Investment Association is delighted to provide input to your consultation. We welcome ESMA's draft guidelines helping regulated firms to implement efficient product governance procedures and target market definitions that will benefit investors.0

The IA's key recommendations to improve the draft ESMA guidelines are as follows:

- It is key for the industry to establish a scalable target market framework that works for mass retail market products. Within the guidelines, ESMA should, therefore, provide an example of a target market definition for non-complex mass retail market products.
- Product risk and investor risk appetite: The draft guidelines do not sufficiently distinguish between the risk level of the product, which is known by the manufacturer, and the risk/reward profile of the investor, which the manufacturer simply does not know.
- Different nature of the services provided by distributors: The target market concept for investment services is different to a product's target market. While professional portfolio managers take investment decisions on their client's behalf and are subject to suitability requirements applying product governance / target market criteria to all products in a portfolio would not improve investor outcomes. The additional administrative burdens and costs on portfolio managers would be high, without adding value for their clients.
- In order to enable the industry to set up systems to exchange the information regarding the target market, more guidance on the communication of sales data back to manufacturers is required.

If you have any questions on our attached response, please get in touch.

On behalf of our membership, yours

Florian van Megen

Retail Markets Specialist

ABOUT THE IA

The Investment Association is the trade body that represents UK investment managers, whose more than 200 members collectively manage over €6.7 trillion on behalf of clients.

Our purpose is to ensure investment managers are in the best possible position to:

- Build people's resilience to financial adversity
- Help people achieve their financial aspirations
- Enable people to maintain a decent standard of living as they grow older
- Contribute to economic growth through the efficient allocation of capital

The money our members manage is in a wide variety of investment vehicles including authorised investment funds and pension funds.

The UK is the second largest investment management centre in the world and manages 37% of European assets.

More information can be viewed on our website.

ANNEX I

CONSULTATION RESPONSE

The investment industry understands and agrees with the legislators' desire to enhance investor protection and in principle agrees with the new product governance requirements in the directive (MiFID II) and the delegated acts (level 2). ESMA's guidelines will help all parties involved in manufacturing and distributing products to investors, who need them to meet their financial aspirations.

Over the past year, the IA engaged in a number of domestic and European industry initiatives discussing implications and practical proposals on how to address the incoming MiFID II requirement to define, communicate to distributors and oversee target markets. The requirements create a big challenge for product manufacturers, especially where they have no close link to the client facing distributors. This is so in both execution only (RTO) or advised sales.

For the industry, the draft guidelines are only a starting point. In order to implement the requirements and deliver better outcomes to customers, firms will have to undergo significant system builds to communicate and digest the information about target markets and sales. This will happen during the course of less than one year before MiFID II becomes applicable in January 2018 and is a challenging exercise for all parties involved. The clearer the guidelines and expectations of the regulator are, the more likely it is that the legislator's expectations can be met and investors continue to have access to all the different types of investment products that can help them achieve their investment aims.

The draft guidelines do not sufficiently distinguish between the risk level of the product, which the manufacturer will know about, and the risk/reward profile of the investor, which the manufacturer will normally not know about. ESMA should take into account that in many cases investment products will be part of a wider portfolio (building blocks). ESMA should not require that the risk profile of the product and the investor are regularly the same. The risk category of the investment portfolio is derived from the range of the investments and their weightings within the portfolio. This is information the manufacturer of just one of those investments has no access to and which can only be evaluated by someone with the whole picture, either the investor or his adviser.

To avoid a disproportionate application of the rules that could threaten other core principles of investing, such as diversification, we recommend further differentiation between the investment services being provided. Each type of investment service fulfils a different purpose for investors and offers a different level of investor protection. The nature of portfolio management services merits its exclusion from the product governance requirements and the concept of "distribution". By hiring a professional portfolio manager a client expects to benefit from expert portfolio construction through a regulated service which affords a higher level of investment protection than other types of investment services. Applying a look through, as if the transactions decided by the manager were made directly by the investor, would ignore the main reason the manager was hired by a client in the first place. We believe the costs would outweigh the benefits in this instance considering the number of financial instruments in existence. This would translate in the reduction of the investment universe managers might be able to access on behalf of the client (for example by not being able to consider financial instruments which have not been assessed but are within the investment guidelines set out by the client), to the detriment of diversified portfolios and the best interests of clients.

Q1: DO YOU AGREE WITH THE LIST OF CATEGORIES THAT MANUFACTURERS SHOULD USE AS A BASIS FOR DEFINING THE TARGET MARKET FOR THEIR PRODUCTS? IF NOT, PLEASE EXPLAIN WHAT CHANGES SHOULD BE MADE TO THE LIST AND WHY.

The IA welcomes the six categories proposed by ESMA and broadly agrees with them. In the IA's view, only all categories read together define a target market for a single product. However, further standardisation and clarification of some categories is necessary to enable manufacturers to define target markets and communicate the information to many distributors and for a large number of products. The more precise the guidelines are, the better the regime will function, as it will enable the industry to install scalable tools that will help to protect retail investors.

Together with other stakeholders in the distribution chain and across Europe we have drawn up the attached framework to define a target market. It reflects the six categories ESMA proposes. From a product manufacturer's perspective, such a framework is necessary to systematically disseminate clear information to distributors across all distribution channels and possibly via several layers of intermediation. The key for a functioning framework and standard is that it is accessible for all stakeholders in the distribution chain. The standardised template, in other words, can be understood as a common lexicography.

This also means that, in our view, the list of categories has to be exclusive and should not be extended by any distributor/intermediary. Otherwise, the coherence of the model gets lost and data about sales coming back to manufacturers from the distribution chain will not be comparable and hence render the oversight obligation impossible.

1. The client type

We agree that the client type category should be aligned with the defined MiFID II client categories. The addition of further categories would not improve the target market definition but rather make it more confusing. Categories such as "semi-professional" and "private wealth" are not consistently applicable in all regulatory frameworks, or are not defined at all.

2. Knowledge and Experience

Manufacturers generally do not have information about investors' knowledge and experience. Defining it would be impossible for them. For this reason, we propose a simple assessment mechanism based on three subcategories, which an be applied by the manufacturer based on his view of to whom the products should be sold. These subcategories are Basic, Informed and Expert.

Basic reflects the need to have a category for the mass retail market that can get access to products with built-in protection and regulated pre-sale disclosure documents (KIIDs or KIDs). With these, even first time buyers without experience should be able to access products appropriate for them (e.g. most non-structured UCITS).

3. Financial Situation with a focus on Ability to Bear Loss

The complication that arises for this category is that different financial instruments are designed to achieve different outcomes. We principally agree with ESMA's suggestions, however, many risk-based investment products, and in particular most funds, do not guarantee outcomes for investors. Furthermore, fund managers generally do not have personalised information about the investors. Therefore it is impossible for manufacturers to come up with concrete figures defining the ability to bear loss in their target market definitions. Fund managers can only make statements about the risk to the capital invested by the investor.

In our framework we, therefore, suggest three subcategories of losses an investor can bear that can be applied by manufacturers of different types of products:

i. Capital preservation or set limited loss
ii. Loss up to the level of the initial investment
iii. Loss beyond the initial investment

In our view, for the reasons mentioned, the case studies within the draft guidelines should also not contain concrete figures or percentages.

4. Risk Tolerance and Compatibility of the Risk/Reward Profile of the Product

In our view, the draft guidelines do not sufficiently distinguish between the risk level of the product a manufacturer can determine and the risk/reward profile of the investor, which the manufacturer does not know. (We discuss further in questions 2 and 4 why matching the two is not helpful for the investors.)

Manufacturers should be required to communicate the risk profile of the product in accordance with other regulatory requirements such as the UCITS KIID regulation, the PRIIPs KID regulation or Prospectus rules. This will provide a uniform approach across products. Additional terminology such as "balanced" or "conservative" is not sufficiently defined and therefore will not be applied in a coherent manner across the single market.

5. Client Objectives

Manufacturers will not be able to define client objectives very narrowly. For example, most fund products can be used appropriately for a number of purposes. Listing all of them would make it more complicated and less transparent for the recipient of the target market definition and therefore unhelpful. In our industry framework, we, therefore, suggest applying categories of objectives with a limited number of options. This is again with the intention to be able to apply them in a standardised system allowing for clear differentiation: (a) Return Profile (preservation, growth, income or other) and (b) Time Horizon (where possible aligned with other regulated product documentation such as UCITS KIIDs or PRIIP KIDs).

6. Client Needs

Client needs will vary widely based on facts such as age, nationality or residency, tax status and others. For products that are designed to serve the mass retail market across several jurisdictions, this cannot be qualified by manufacturers. On the other side, not all products are designed to meet distinct client needs but could serve a number of purposes. We, therefore, propose to use two standardised subcategories: usage and access (see appendix). These can be applied universally and will give a clear overview of what the investor can expect from and under which conditions the investor can get the invested capital, including returns, back.

Q2: DO YOU AGREE WITH THE APPROACH PROPOSED IN PARAGRAPHS 18-20 OF THE DRAFT GUIDELINES ON HOW TO TAKE THE PRODUCTS' NATURE INTO ACCOUNT? IF NOT, PLEASE EXPLAIN WHAT CHANGES SHOULD BE MADE AND WHY.

The IA agrees with the proportional approach set out in paragraphs 18-20 of the draft guidelines. In our understanding, this means that a lesser level of detail in the target market definition is required for mass market products than for more complicated products. It would be very helpful if ESMA could provide a case study of a target market description of such products within the finalised guidelines.

In the case of tailored products, we believe the target market definition is obsolete. Whether the engagement with the client who requires the bespoke product or service takes place directly with a manufacturer (typical in the institutional environment) or with a distributor (for example a consultant in the pensions environment), the investor protection will be maintained by the requirements of suitability.

Q3: DO YOU AGREE WITH THE PROPOSED METHOD FOR THE IDENTIFICATION OF THE TARGET MARKET BY THE DISTRIBUTOR?

The IA believes that the application of the proportionality principle should be extended to distributors. Certainly, for mass market products, which by definition should not have any limitations in terms of to whom they can be marketed and distributed, distributors should be able to rely on the manufacturer's target market.

Furthermore, ESMA should take into account that distributors are delivering a service to their clients that is not necessarily about distributing single products. And it should not be. Therefore, depending on whether products are being made available via RTO services or whether advice is given, or portfolios are managed on a discretionary basis, the relation between the distributor's and manufacturer's target market for products will vary. In our view, the more responsible the distributor is for the investor's outcome (suitability in the case of advice and portfolio management), the less important the manufacturer's target market definition will be for the investor. In the case of portfolio management, we would argue that the manufacturer's involvement and responsibility is very limited since investment decisions are taken by a professional intermediary.

Q4: DO YOU AGREE WITH THE SUGGESTED APPROACH ON HEDGING AND PORTFOLIO DIVERSIFICATION ASPECTS? IF NOT, PLEASE EXPLAIN WHAT CHANGES SHOULD BE MADE AND WHY.

The IA agrees that in the case of hedging and portfolio management the target market definition of manufacturer and distributor can diverge. According to feedback from our membership and direct engagement with distributors it became very clear that this happens on many occasions. In particular, when it comes to the description of the risk tolerance (category 4), a too tight alignment of product risk and investor risk approach might lead to unintended and detrimental consequences. Cautious distributors might limit their offerings. Consequently, the important diversification of client's portfolios might not be possible anymore. Therefore, the formulation that sales outside the target market shall not occur "on a regular basis" needs to be removed from paragraph 32 on page 10 of the consultation paper.

Q5: DO YOU BELIEVE FURTHER GUIDANCE IS NEEDED ON HOW DISTRIBUTORS SHOULD APPLY PRODUCT GOVERNANCE REQUIREMENTS FOR PRODUCTS MANUFACTURED BY ENTITIES FALLING OUTSIDE THE SCOPE OF MIFID II?

Yes. Since not all authorised product manufacturers in Europe are MiFID firms (e.g. UCITS Management Companies and AIFMs) it is currently unclear for MiFID distributors how to deal with such manufacturers. Most likely most manufacturers will provide a target market definition to distributors upon their request.

Furthermore, national competent authorities might have different requirements in terms of oversight of sales in and outside the target market for non-MiFID firms. Since fund distribution is a widely established cross-border activity in the EU, this can significantly influence the ability for manufacturers and distributors to work together in serving investors.

In order to provide a level playing field for products, and to promote investor protection, further guidance is required on how the product governance requirements shall be applied where non-MiFID entities are involved in the supply chain as manufacturers or distributors.

Q6: DO YOU AGREE WITH THE PROPOSED APPROACH FOR THE IDENTIFICATION OF THE 'NEGATIVE' TARGET MARKET?

The IA agrees. However, the proportionality principle should apply here as well. For mass retail products, no additional negative target market should have to be expressed by product manufacturers. The purpose of a negative market should be to single out hard cases and investors for which certain products should not be used or to whom they should not be offered. At the same time, the negative target market should not be the mere opposite of the original target market. As a consequence, a grey area will emerge between the two.

Q7: DO YOU AGREE WITH THIS TREATMENT OF PROFESSIONAL CLIENTS AND ELIGIBLE COUNTERPARTIES IN THE WHOLESALE MARKET?

Yes. The IA agrees that the product governance rules as drafted, with the most vulnerable investors in mind – retail clients, should be applied in a proportional manner to professional clients.

Professional clients and eligible counterparties do not require the same level of protection, also because products offered to them are generally more tailored to their needs. The target market definition, as stated in our answer to question number two, in these circumstances is obsolete.

Q8: DO YOU HAVE ANY FURTHER COMMENT OR INPUT ON THE DRAFT GUIDELINES?

The asset management industry is heavily intermediated and there is often no direct legal relationship between manufacturers and intermediaries within the distribution chain. We would welcome further clarification in the draft guidelines of what sales data is to be provided by distributors to manufacturers, in order to ensure that it is scalable, meaningful and consistent. Currently, there is a lack of clarity regarding the approach to communication of sales data. It would be helpful to know whether the expectation is that distributor firms will report on an "exceptions" basis where products are being sold outside of the target market or whether all sales information needs to be provided to manufacturers via the distribution chain. It would be our expectation that proportionality means that where products are aimed at mass market investors, there may not be any exception reporting or indeed sales outside of target market.

Additionally, we do not agree with the expectation that manufacturers should define via which medium a distributor markets the products to clients (face-to-face, via telephone, online, etc. – see paragraphs 21 and 22 of the draft guidelines). If a fund manufacturer is comfortable that a product is distributed via execution only and expresses that via the target market definition, distributors should decide which medium is best suited.

Q9: WHAT LEVEL OF RESOURCES (FINANCIAL AND OTHER) WOULD BE REQUIRED TO IMPLEMENT AND COMPLY WITH THE GUIDELINES

The IA does not have access to data on costs members incur as a result of the implementation of MiFID II. It is, however, clear that in all areas where new reporting and information communication systems have to be designed and implemented, such costs will be very high. For this reason, we restate our request that the guidelines need to be as specific as possible to allow the industry to build efficient, effective and scalable information exchange standards.

APPENDIX 1

TARGET MARKET FRAMEWORK			OPTIONS (FOR EACH OPTIO OPTIONS (FOR EACH OPTION, UNLESS STATED OTHERWISE)N, UNLESS STATED OTHERWISE)
Client Type	• Retail • Professional • Eligible Counterparty		*Y = Directly in the target market* *N = Clearly outside of the target market (Negative Target Market)* *Blank = Manufacturer wasn't designing the product for this use but accepts it may be compatible*
Knowledge & Experience	• Basic • Informed • Expert		*Y = Directly in the target market* *N = Clearly outside of the target market (Negative Target Market)*
Ability to bear losses	• The investor seeking to preserve capital or can bear losses to a level specified by the product structure • The investor can bear losses • The investor can bear losses beyond the investment amount		*Y = Directly in the target market* *N = Clearly outside of the target market (Negative Target Market)*
Client objectives	**Return profile:** • Preservation • Growth • Income • Other	**Time Horizon:** • Short (e.g. <3 years) • Medium (e.g. > 3 years) • Long (e.g. > 5 years)	*Y = Directly in the target market* *N = Clearly outside of the target market (Negative Target Market)* *Blank = Manufacturer wasn't designing the product for this use but accepts it may be compatible*
Client needs	**Usage:** • Solution • Core or Component of a Portfolio • Hedging • Speculation • Other e.g. Sharia, Ethical, Tax mgt	**Access (withdrawals):** • Ready access – normal market conditions • Ready access with restrictions • Access uncertain	*Y = Directly in the target market* *N = Clearly outside of the target market (Negative Target Market)* *Blank = Manufacturer wasn't designing the product for this use but accepts it may be compatible* *Access – Y for one option only, N for the others.*
Risk	• SRRI (or equivalent) • Key risks of which the investor must be aware		*SRRI is a simple integer 1 – 7* *Key risks*
Distribution Strategy			
Channel	• Execution Only – retail (RTO) • Execution Only with Appropriateness Assessment – retail (RTO) • Investment Advice - retail • Portfolio Management - retail • Non-Retail	Note: Local strategies such as placement (Italy) and marketing/ guided sales (Spain) also remain under discussion	*Y = Directly in the target market* *N = Clearly outside of the target market (Negative Target Market)* *Blank = Manufacturer wasn't designing the product for this use but accepts it may be compatible*