

# CONSULTATION PAPER OF ESMA

## Draft guidelines on MiFID II Product Governance requirements

### AMAFI comments

Association française des marchés financiers (AMAFI) is the trade organisation working at national, European and international levels to represent financial market participants in France. It mainly acts on behalf of credit institutions, investment firms and trading and post-trade infrastructures, regardless of where they operate or where their clients or counterparties are located. AMAFI has more than 135 members operating for their own account or for clients in different segments, particularly organised and over-the-counter markets for equities, fixed-income products and derivatives. Nearly one-third of its members are subsidiaries or branches of non-French institutions.

AMAFI welcomes the opportunity to comment on ESMA's consultation paper regarding the draft guidelines on MiFID 2 product governance requirements. Before responding to the specific questions of ESMA's consultation document, we would like to point out the following general comments.

## 1. Introduction

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AMAFI globally welcomes those Draft guidelines (ESMA/2016/1436) and the opportunity to comment them. Indeed, on a such important matter, ESMA's work must be sufficiently well informed, not only by more in-depth exploration of viewpoints emerging from discussions led by each national regulator, but also by the open and transparent expression offered by a public consultation process. In that context, AMAFI would like to highlight that the same need has been expressed about other MiFID II issues, such as costs and charges for instance, even if they do not take the form of Guidelines, which as such have to be submitted to a public consultation.

AMAFI fully supports ESMA approach that Guidelines on Product Governance must take into account the type of product in compliance with proportionality principle. We also welcome the effort of simplification for criteria of target market made by ESMA to finally determine "only" 6 criteria.

However, some critical issues persist inside those Guidelines:

- AMAFI regrets that Manufacturers must use the 6 criteria to identify the target market even for vanilla products (as ordinary shares for example). Indeed, the result is that marketing of equities or bonds issued by a firm could have to follow the same procedure as that used for a complex product. This would result in an unnecessarily administratively burdensome framework which, rather than being proportionate to the actual risk incurred by retail investors, could lead to restricted target market definitions, thus limiting the options for distributing financial instruments which, as shares, are critical to the effective financing of the economy and to the ability of companies to invest ;

- AMAFI strongly disagrees with the fact that the objective of diversification is not taking into account. Diversification actually occurred on regular basis and is a key element for investors and so for Manufacturers and Distributors have to take it into account. Indeed, diversification is a key element of the offer and the management of clients' investments as it permits to mitigate the risks or to enhance the performance. For that reason, ESMA could not explain that diversification "should not occur on a regular basis" (*Background of the draft guidelines, Paragraph 32*). Diversification should be an explicit item included in the target market for instance under criteria 'Clients' Objectives';
- As detailed in our answer to Question 6, AMAFI disagrees with ESMA's approach of identification of the "negative target market".
- As explained in our answer to Question 8, AMAFI requires a 'non-narrative' approach to express the target market (as opposed to the examples given in the Annexe of the Guidelines) in favour of a standardized format far more compatible with automated processes;
- AMAFI is opposed to the treatment of eligible counterparties when they act for their own accounts and have no intention to offer products to end investors. In such cases, we are not facing "Manufacturers" or "Distributors", so Product Governance should not apply since it would contradict Level 1 definitions;
- AMAFI would like further clarification on the following issue: where an investment firm provides RTO service, should it be always considered as a Distributor within MiFID II Product Governance definitions? Where an investment firm receives an order in a complete "passive way" (without any form of marketing campaign, recommendations or advices to customers on the product concerned or the sending of promotional communications) on a financial instrument with which he has absolutely no link whatsoever (he does not know the 'manufacturer' nor does the 'manufacturer' pay him a fee) and the unique service offered to the client is to transmits the order for execution, does he actually "offer" or "propose" that financial instrument or "decide [to include it in] its range"?. If so, it means that all RTO investment firms that receive – for instance - an order on the secondary market on an ordinary share should be considered as MiFID II Distributor distributing products that will be often not manufactured by entities subject to MiFID II (e.g. a corporate issuer). If so, such investment firms are required to comply by themselves (without the possibility to rely on a manufacturer) with Product governance requirements. Would that not be unnecessarily burdensome? Could that not result in limiting the options for distributing financing instruments which, as ordinary shares or corporate bonds, are financing the economy? One can say though, that in line with proportionality principle, such products "*would be compatible with the needs and characteristics of mass retail market*" and therefore, the requirement of defining a target market will not be so burdensome. But, in that way, what will be the actual benefit in defining such 'target market'? Even so, Product Governance requirements are not limited to the definition of a target market. Distributors have other requirements to comply with.
- Moreover, AMAFI strongly disagrees with the requirements for Distributors to use "*any further information and data deemed reasonably useful that may be at their disposal and gathered through other sources*" as it is in disagreement with execution only service where only a limited amount of information on clients is required and so available for Manufacturers and could not be implemented on IT systems. If such requirement applies, it could have the same effect than a product ban for self-directed investors buying execution only through online brokers.

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## 2. Responses to ESMA Questions

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

AMAFI partially agrees with this proposal.

AMAFI feels those Guidelines better reflects industry's concerns and welcome the fact that ESMA shortened its first proposal to only list 6 criteria instead of 9 which is more operational for financial institutions.

AMAFI agrees that criteria should be assessed by the Manufacturer with a product-centric approach. Indeed, Manufacturers can only to assess the target market with an abstract approach as they do not necessarily have direct contact with clients (*Background of the draft guidelines, Paragraph 12*).

AMAFI notes that some issues persist:

- Manufacturers must use the 6 criteria to identify the target market even for vanilla products (as ordinary shares for example): "*Manufacturers should use the list of categories set out in these guidelines as a basis for identifying the target market for their products. The list of the categories is cumulative: each manufacturer should assess the target market at least for each of those categories*" (*VI. Guidelines for manufacturers*). For such products suitable for all clients' categories, even mass retail one, it does not seem necessary to complete other criteria than "*the type of clients to whom the product is targeted*" once "mass retail" was completed in this category;
- This requirement seems actually disproportionate in spite of the "proportionate manner" which should be use to identify the target market "*The identification of the target market assessment should be done in an appropriate and proportionate manner, considering the nature of the investment product*" (*VI. Guidelines for manufacturers*).

Considering the definition of each criterion, AMAFI globally agrees with the list provided.

(a) The type of client to whom the product is targeted

AMAFI agrees with this proposition but would specify that "*additional description*" should be used only when it is necessary.

Nevertheless, AMAFI's members needs to have further specifications about professional clients: do Manufacturers have to make a difference between professional per se and opt-up professional in the target market or could they consider all of them as "professional clients"?

(b) Knowledge and experience

AMAFI globally agrees with this proposition and the possibility to compensate limited or no experience with extensive knowledge but needs to have further clarification. For example, for AMAFI specification should be made whether investors need to have specific knowledge about the product's family characteristics and/or about the technical characteristics of the product.

However, situations where the client neither has knowledge nor experience for the contemplated investment can be complicated to overcome. In this context, AMAFI considers that the lack of knowledge can be compensated through the explanations provided to clients (for instance, through investment advice) so that they can get a proper understanding of the product together with a subsequent suitability test.

(c) Financial situation with a focus on the ability to bear losses

AMAFI partially agrees with this proposition. We note however that the examples provided are more focused from the Distributor standpoint. From a Manufacturer perspective, the ability to bear losses must be theoretical only and based on the mechanism of the product: For instance, is there a guarantee or a protection of the capital invested?

(d) Risk tolerance and compatibility of the risk/reward profile of the product with the target:

AMAFI partly agrees with this proposition since it should not be a requirement to rely on PRIIPs.

Firms should be enabled to determine a way to categorize their products between a risk oriented attitude or a conservative one that would be applicable to all products, PRIIPs or not PRIIPs. Firms should also be enabled to choose to rely or not on PRIIPs risk indicator.

In any case, PRIIPs risk indicator could be used only for financial products subject to PRIIPs Regulation (that means only for “packaged retail and insurance-based investment product” sold to retail investors).

Moreover, for AMAFI, hedging products need a specific approach. Indeed, the risk tolerance assessment for such products is not economically relevant. The risk/reward profile is not a trigger for purchasing a hedging product (the needs for hedging are). The risk is actually directly balanced with the hedging purposes of the product and not the reward. A theoretical risk tolerance analysis by the Manufacturer for hedging products is not relevant. This criterion should be carved out for such products. If it is not possible, Manufacturers should be able to create a specific category for risk tolerance renamed “hedging compatibility” for instance.

(e) & (f) Clients’ Objectives and Clients’ Needs:

AMAFI doubts the usefulness to make a distinction between Clients’ objectives and Clients’ needs. We propose to merge those two linked categories. As examples provided in the Consultation Paper do not explain the need to make such a difference. AMAFI considers then it is not operationally relevant to distinguish between clients’ objectives and clients’ needs.

Moreover, considering the different levels of requirements between Distributors and Manufacturers, those Guidelines specify that the identification of the target market for Manufacturers should be “more abstract” as they do not have direct client contact. So, AMAFI feels that asking Manufacturers to determine theoretically the retirement provision, or age, or tax residence, etc. objectives or needs of products is not possible and should be identified by Distributors only.

To conclude, AMAFI proposes to merge those two categories. If it is not possible, AMAFI proposes to define, for Manufacturers, “Clients’ Needs” as the investment horizon of the product and to add details on its characteristics and its purpose in “Clients’ Objectives”.

**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.**

AMAFI agrees with this approach and does not find a need for ESMA to provide further details.

However, in the case of non-advised services relating to simpler and more common products (*Draft guidelines, Paragraph 17*), it could be clearly stated that the target market could potentially include all the firm's clients for this service.

AMAFI fully agrees with proposal of Draft guidelines Paragraph 20 that *"for bespoke or tailor-made products, the target market of the product will usually be the client who ordered the product"*

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

AMAFI does not fully agree with ESMA method.

On one hand, AMAFI supports the principle that the assessment of the actual target market is influenced by the services provided by Distributors. In particular, where firms only carry out execution services with the assessment of appropriateness, this assessment will be limited to the sole categories of knowledge and experience of clients. In this respect, AMAFI agrees with ESMA when it states that *"firms should take into due consideration the distribution strategy suggested by the manufacturer"*.

On the other hand, AMAFI disagrees with the footnote 16 which seems to contradict the explanations given in that § 39 when ESMA says that *"even firms providing investment services under appropriateness or execution-only regime, could be in the position to conduct a more thorough assessment of the target market"*. On the contrary, AMAFI considers that under execution only regime, by nature, no thorough assessment of the target market could be performed and therefore should be required. Under appropriateness regime, the assessment is limited to the sole categories of knowledge and experience, as stated in § 39. AMAFI proposes to delete the footnote 16 (*page 28*) and footnote 8 (*page 11*).

AMAFI totally disagrees with the following approach *"distributors should conduct a thorough analysis of the characteristics of its client base, [...] and should use any information and data deemed reasonably useful and available for this purpose"* (*Draft guidelines, Paragraph 33*). This approach is opposed to the principle of proportionality and the over-all approach regarding common products and/or execution only service where only a limited amount of information on clients is required.

For AMAFI, ESMA concern is already dealt with in § 35, with the definition of product assortment of Distributors and the fact that they should take into due consideration products characterized by complexity/risk features or significant conflicts of interests. As stated in that paragraph, in that respect, Distributors should conduct definition of product assortment in line with Manufacturer target market and distribution strategy.

AMAFI proposes therefore the following method: First, it should be clarified that Distributors should assess only target market's criteria that they can match with available information depending on the service provided ('matched or assessed criteria'). Alternatively, and for criteria that could not have been assessed, ESMA could provide guidance that those ('disclosed criteria') have to be disclosed to clients.

Moreover, considering the principle of proportionality, for products compatible with mass retail market (as define in the first criterion of the target market), Distributors should not have to perform a thorough target market assessment (*Draft guidelines, Paragraph 41*).

Regarding the requirement to report deviation, AMAFI would highlight that information reported should depend on the investment service and/or the product provided. For example, when Distributors provide execution only services, they could not know whether investors fall within the target market or not. Likewise, when those Distributors provide subject to appropriateness, their *ex-post* verifications of the effective reaching of the target market will only be based on the knowledge and experience criterion.

**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.**

AMAFI agrees with the importance to make some clarifications on hedging and portfolio diversification approach as such products represent a significant proportion of the total transactions carried out and are essential for all stakeholders, in particular for investors.

AMAFI does not agree with the requirement which mentioned that investments for diversification purpose “*should not occur on a regular basis*” (*Background of the draft guidelines, Paragraph 32*). Indeed, as previously mentioned in the introduction, a product could be used to diversify the portfolio of several clients. The diversification purpose should be defined regarding the proportion of the investment inside the clients' portfolio. Moreover, “regular basis” could be differently defined by Competent Authorities across European Union and create an unfair competitive as it is a highly subjective criterion. AMAFI proposes to delete this sentence.

For AMAFI, a new item could be added for the definition of the target market: could this product used for diversification? Nevertheless, in case of diversification, the criterion “Risk tolerance and compatibility of the risk/reward profile of the product with the target” should match the characteristics of client’s entire portfolio and not only the ones of the product.

AMAFI proposes to add a multiple choices question into the criteria “Clients’ Objectives” or “Client Needs” (as AMAFI proposes to merge it): Is the product:

- a core investment product and/or
- a hedging product and/or
- a diversification product.

AMAFI proposes ESMA to make a distinction in its Guidelines between deviations from the target market and diversification.

Furthermore, AMAFI considers that deviations from the target market for diversification purpose should not be reported by the Distributor to the Manufacturer. Indeed, such information is not relevant for Manufacturers as the deviation is neither linked to a wrong definition of the target market nor an inappropriate sale of the product by the Distributor. AMAFI proposes to mention this point in the Guidelines.

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

AMAFI needs further guidance on the scope of MiFID II Products Governance.

Firstly, should Manufacturers apply those requirements if they work with 'distributors' falling outside the scope of MiFID II?

For AMAFI, it would be complicated for Manufacturers to comply with Product Governance requirements when they are facing 'distributors' outside the scope of MiFID II. AMAFI understands that MiFID II's requirements could be negotiated and formalized within contracts signed with such 'distributors'. For AMAFI, this explanation is outside of economic and legal realities. Particularly in the following cases:

- the power balance is clearly against Manufacturer who will have less capacity to impose its own obligations (especially MiFID II ones) moreover if 'distributor' is not subject to any legal requirement to fulfill those;
- the 'distributor' is not subject to MiFID II (Insurers in particular);
- the 'distributor' is not subject to the law of a Member State, and so, is not in essence subject to MiFID II.

Finally, regarding the fact that distributors should made their own target market if the product's Manufacturer is outside the scope of MiFID II, AMAFI would ensure that, in this case, distributors do not have any reporting obligation towards non MiFID II Manufacturers.

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

AMAFI is totally opposed to that approach. For AMAFI, if a product should not be sold to some categories of clients, such categories should be explicitly disclosed in the definition of the target market itself (using the "Client type" and "Knowledge and experience" criteria) to prevent any sale by Distributors.

AMAFI supports the ESMA's proposal (*Draft guidelines, Paragraph 59*) that the negative target market can be defined by simply stating that the product or service is incompatible for any client outside the positive target market. Therefore there is no need to formulate a negative target market, it is a redundant exercise. At least, and in line with the proportionality principle, the negative target should only be used in very exceptional situations where the sale of a product could potentially be detrimental to a specific category of investors and to whom consequently the product could never be sold but not on a case-by-case basis.

In any ways, product could still be sold to investor belonging to the negative target market if the investor asks for it on its own initiative and the Distributor has made all relevant disclaimers.

Distributors could absolutely not being in the situation where they refuse to sell a product that being illegal at least in French Law.

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

No, AMAFI does not agree with the treatment of professional clients and eligible counterparties in the wholesale market.

AMAFI agrees with § 66 to 69 of the Guidelines but totally disagrees with the other paragraphs related to professional clients and eligible counterparties.

AMAFI thinks that Product Governance only applies when there is a Manufacturer facing a Distributor. In some cases, there are no Distributors and Product Governance should not apply.

Article 16.3 is an organisational rule and as such applies irrespectively of the clients' categorization. Therefore, requirements of article 16.3 apply even if the financial instrument is sold to an eligible counterparty. However, it specifically target "Distributor" as the counterparty of the Manufacturer for the requirements of providing information on the financial instrument and the product approval process including the identified target market. Therefore, article 16.3 applies to all categories of clients including eligible counterparties but provided that such counterparties act as a *Distributor*. This is actually consistent with article 24.2 which provides that needs of the target market should be the ones of the *end* clients. Even if article 24.2 should not apply in relation with eligible counterparties, the targeted "clients" that need protection are actually the end clients of such counterparties. Therefore, article 24.2 applies even if the direct counterparty of the Manufacturer is an eligible counterparty provided that it is a Distributor with end clients.

If the eligible counterparty "buys" a financial instrument or negotiates a transaction on such financial instruments with an investment firm for its own account, with no intention of reselling it to other clients it does not act as a Distributor. It is the one and only "client" or the counterparty of the firm for a "one shot" transaction. For instance, an investment firm negotiates a derivative for hedging purposes with another investment firm. The first firm is acting for its own account and will keep the position in its own book as long as it needs. It is neither a Distributor nor a client. There is not any "end clients". Therefore, there is no "target market" to identify. Product Governance does not apply.

Nonetheless, if ESMA considers Product Governance applies in such cases, AMAFI proposes to adopt a proportionate approach when the end-client is an eligible counterparty. For instance, if Manufacturers answered "only eligible counterparties" in the first criterion, it permits not to answer the five other criteria. Moreover, such answer should permits not to sent pre-trade information, not to monitor the sales and not to send a review to the so-called 'manufacturer'.

§ 20 of the Guidelines reduces the requirements for assessing the target market when the underlying product is a bespoke product or a tailor-made one. AMAFI agrees with this approach but wants to underlie that Product Governance is not only composed of target market identification but also with the following requirements: defining a distribution strategy, contracting agreements between Manufacturer and Distributor, product monitoring and reporting requirements. For AMAFI, all of Product Governance requirements should be alleviated when the underlying product is a bespoke product or a tailor-made one.

Moreover, all products dealing between eligible counterparties are not tailor-made or bespoke. So, alleviations mentioned above should concern all products sold to eligible counterparty when it does not act as a Distributor.



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

AMAFI considers that the specification of the preferred acquisition channel should not be proposed by Manufacturers since they do not possess sufficient information necessary for this assessment.

AMAFI is also concerned that these guidelines seem to be essentially fitting a distribution model where the Manufacturer and its Distributors have a direct relationship and as such can outline their mutual responsibilities in a written agreement. They seem difficult to implement for listed products as well as for all Distributors working in open architecture.

Examples given in the Annex 4 of the Consultation Paper are too narrative and so not operational. Indeed, Manufacturers and Distributors need to have synthetic description in order to automate this process. Moreover, in light of the volume of products that are issued annually, AMAFI would like ESMA to confirm that those rules are compatible with automated processes. Indeed, it is important not to lose sight that the definition of a standardized format for target market description is a prerequisite for a smooth functioning of the two-way communication between Manufacturers and Distributors – which will take place in a “one-to-many” configuration and relate to a very high number of product references.

AMAFI is interested in the interaction between MiFID II Product Governance requirements and rules on data protection. Regarding the fact that such rules differ from a country to another, are those requirements considered as “legal requirements” that would allow firms to compile and process such information without being in breach of rules on data protections (including sensitive information sharing between Manufacturers and Distributors)?

Finally, AMAFI strongly disagrees with the requirements for Distributors to use “*any further information and data deemed reasonably useful that may be at their disposal and gathered through other sources*” as it is in disagreement with execution only service where only a limited amount of information on clients is required and so available for Manufacturers and could not be implemented on IT systems. If such requirement applies, it could have the same effect than a product ban for self-directed investors buying execution only through online brokers.

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

Given the uncertainty on many levels and based on the assumptions taken so far, the implementation into the IT systems will be very costly.

Costs will be twofold:

- One-off costs (IT and implementation costs) that may be broken down as such:
  - Initial IT investments;
  - procedural enhancements (business, compliance and legal);
  - consultancy fees;
  - trainings costs;
  - Legal costs, including the repapering with Distributors.

- Running costs:
  - Running IT costs (technology and use of product data);
  - control and compliance costs;
  - information exchange.

As regards IT costs, in addition to the development of analytical tools, AMAFI wishes to stress the importance of costs for setting up new platforms for exchanges between Manufacturers and Distributors.

