

22 December 2016

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## **WMA's<sup>1</sup> Response to ESMA's Consultation Paper on Draft Guidelines on MiFID II product governance requirements**

### **Introduction**

Although a number of WMA member firms manufacture products, the primary focus of our review of the Guidelines had been from the perspective of distributors; an activity undertaken by all of our firms.

### **General observations**

Our responses to the questions in the consultation are set out in the preceding section. We set out below some general observations.

- **Execution only clients** – Firms conducting execution only business continue to be unclear as to what obligations fall upon them, given that, in most cases, they know nothing about their clients' circumstances. We expand on this point further in our response to the detailed questions.
- **Information required by manufacturers for mass market products** – Whilst the Guidelines state that '*Manufacturers should consider, on a proportionate basis, what information they need in order to complete their review and how to gather that information*' we believe the Guidelines should also emphasise that the focus should be to collect **relevant** data to enable the manufacturer to gain assurance that their products are being correctly distributed. We have seen proposals from manufacturers of mass market products in the UK which appear to be requesting data which is not relevant. It would be helpful if the case studies in the Guidelines had an example or examples of mass market products.
- **Terminology** – We had feedback from our members that some of the terminology in the Guidelines is confusing. The following terms/phrases are used to describe target market:
  - Target
  - Actual Target
  - Positive Target

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<sup>1</sup>The Wealth Management Association (WMA) is a trade association that represents 183 wealth management firms (full members) and associate members who provide professional services to our full member firms.

WMA members firms look after over £760 billion of wealth for over 4 million retail investors.

WMA full members deal in stocks, shares and other financial instruments for individuals, trusts and charities through a range of services spanning execution only, advisory and discretionary fund management.

The WMA exists to support its members and their clients through education and engagement, advocacy and influence, research and analysis and by playing an active role as a facilitator and thought leader.

WMA firms operate across more than 580 sites, employing over 32 000 staff. These firms also run over 5.5 million client portfolios and carry out over 20 million trades a year.

- Negative Target
- Area between Positive and Negative

Our understanding is that what is intended is simply the following, but consistency of terminology/clarification would be helpful:

- (1) Target - who the manufacturer had in mind when designing the product;
- (2) Negative - those for whom the product shouldn't ever reach (we would expect this to be clearly defined by product manufacturers);
- (3) Non-target - everything in between Target and Negative, e.g. where the product might be suitable in a portfolio context or for someone's particular circumstances not envisaged by the manufacturer, or for execution only.

## Responses to Questions

**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 type of clients to whom the product is targeted – Para 16(a)

*'The firm may use additional descriptions commonly used in the respective market like "private wealth clients" or "sophisticated clients" to refine the categorisation but should specify the criteria that must be met in order to categorise clients in this way.'*

Our view is that the Guidelines need to be strengthened to ensure that any additional descriptions are comprehensively defined. The term 'private wealth clients' does not have a common meaning; we tend to use the term 'retail clients' precisely because it is defined in the legislation. In contrast, the FCA Handbook makes reference to 'certified sophisticated investors' which does have a defined meaning which would not necessarily correspond with the term 'sophisticated clients'.

### Knowledge and experience – Para 16(b)

We note the statement that *'Knowledge and experience may be dependent on each other in some cases'*. This is not our understanding of this position. Our understanding is that "knowledge and experience" should be addressed jointly. The assessment is not a separate assessment of a client's knowledge and a separate assessment on a client's experience. There is always an obligation to assess knowledge and experience, not just "in some cases". This is correctly reflected in the example made in the Guidelines, where *"an investor with limited or no experience could be a valid target client if they compensate missing experience with extensive knowledge"*. The risk of leaving the statement as drafted is that target market descriptors submitted by manufacturers will not recognise the interdependency between knowledge and experience, and end up considering them as two separate items. We are concerned that if this situation is not addressed, this will result in a tick box approach and inexperienced investors with excellent product knowledge will be outside of the product's target market.

### Financial situation with a focus on the ability to bear losses – Para 16(c)

We do not understand what is meant by the sentence *'This could also be phrased as a maximum proportion of net investable assets that should be invested'*. Firms have to make an assessment that the client can financially bear any related investment risks consistent with his investment objectives. In making such an assessment. MIFID I provides that *'the information regarding the financial situation of a client must include, where relevant, information on the source and extent of his regular income, his assets, including liquid assets, investments and real property, and his regular financial commitments.'* We are unclear what is meant by the term *'net investable assets'* and whether or not it is information firms are required to obtain.

### Risk tolerance and compatibility of the risk/reward profile of the product with the target market – Para 16(d)

Our understanding is that the term 'risk tolerance' is specific to a particular client; it is an assessment of the client's financial and mental ability to manage risk and withstand risky events. Various steps within the suitability process are designed to determine the client's risk tolerance.

We are unclear what is meant by the term 'risk tolerance' in the context of a specific product. We do recognise that the degree of risk associated with the product should be explained in the target market descriptors and such information would be one of the factors considered by distributors in ensuring they meet any suitability obligations.

#### Clients' Objectives – Para 16(e)

We are unclear what is meant by terms such as '*liquidity supply*' and '*retirement provision*' such terms need to be defined. MIFID I provides that '*the information regarding the investment objectives of a client must include, where relevant, information on the length of time for which he wishes to hold the investment, his preferences regarding risk taking, his risk profile, and the purposes of the investment.*' Specification of the investment objectives of target clients must have regard to the information that may be held by distributors.

#### Clients' Needs – Para 16(f)

It may be helpful if the Guidelines recognised that in many cases assessing client needs means providing additional information without restricting the target. For example, a 'green investment' does not necessarily mean that a product has not hit a target market if it bought by a client that has not specified 'green investments.' We are unclear in what circumstances a client's age would be a factor.

**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.**

We agree with the proposed approach set out in paragraphs 18-20. As we have already mentioned, we continue to have reservations that mainstream mass market products will have detailed target market descriptors which will inhibit the distribution of such products and/or increase the costs of distribution. We do believe that ESMA and the NCAs should carefully monitor this issue during the first 18 months following the implementation of MIFID II particularly in light of ESMA's view that '*Manufacturers should consider, on a proportionate basis, what information they need in order to complete this review and how to gather that information.*'

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

We would refer you to our response to question 1. Our expectation is that the majority of products distributed by our member firms will be mass market instruments. Assuming that the Guidelines are applied in a manner that is appropriate and proportionate our expectation is that most of our firms' work in this area will be ensuring non-mass market products hit the correct target market. Our main concern is in respect of execution only brokers. The Guidelines fail to adequately address how execution only brokers are expected to meet their obligations. The majority of transactions undertaken by execution only brokers are in non-complex instruments and an appropriateness assessment will not have been conducted on clients. The client information held by execution only brokers will be that required to meet money laundering obligations, assess credit risk and effect settlement. Such information is of limited use in determining the characteristics of the client base. Paragraph 27 makes reference to other sources of data such as complaints but feedback from execution only brokers suggest that complaint data is of limited use as the vast majority of complaints relate to administrative issues. We would welcome more detailed guidance as to how execution only firms should meet their obligations where the information held about their clients is very limited.

**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**

We note the comment in paragraph 29 that '*Many investors think about the different parts of their portfolio in different ways.*' Whilst some investors may think about their portfolio in the manner outlined in paragraph 29, many do not. In particular, many investment firms make it clear that clients should invest for the long term; at least five to ten years. In these circumstances, firms will often check, as part of their assessment of the client's ability to financially bear any related

investment risks consistent with his investment objectives, that the client has sufficient liquid funds outside the portfolio to meet short term needs.

Paragraph 30 states that *'The perspective of the target market assessment is the individual product.'* However, the consultation paper fails to adequately recognise that, in respect of discretionary clients and advisory managed clients', suitability is determined by reference to the composition of the portfolio as a whole, which would be clearly documented in the information provided to clients. The individual products are components of the clients' overall portfolio. In effect it is the sum of the products' target markets that must be suitable for the client. Consequently, a medium risk portfolio could contain a mix of high, medium and low risk instruments, provided the portfolio as a whole is medium risk. We are unclear on what basis ESMA has reached the conclusion that this should not occur on a regular basis. Equally, we are unclear why a decision to trade or a recommendation to buy a product which does not distort the overall risk profile of the client's portfolio is a distribution outside the target market.

Whilst we accept manufacturers can only define a target market in respect of their product, the Guidelines fail to adequately recognise that an individual client's suitability obligations are often not determined by reference to the characteristics of individual products. The proposals in the Guidelines will lead to the perverse situation that firms are meeting their suitability obligations but are having to regularly report to manufacturers that their product is being used outside the target market.

**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?**

Further guidance would be helpful. In particular, if a manufacturer outside the scope of MIFID II has chosen to assist MIFID II distributors by providing comparable information to MIFID II manufacturers to what extent can distributors place reasonable reliance on the information?

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

We broadly agree. The Guidelines should make clear that the standards used to describe positive target markets should also apply to descriptors of negative target markets and in particular terminology should be precisely defined.

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

Yes

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

Articulation between the distribution strategy of the manufacturer and its definition of the target market:

Paragraph 20 of the Guidelines states that the manufacturer *'should also specify the preferred acquisition channel (face-to-face, via telephone, online, etc.)'*. The Guidelines fail to explain what factors the manufacturer should consider to determine the preferred acquisition channel and we would question on what basis a manufacturer is able to determine the preferred acquisition channel. The manner in which distributor firms engage with their clients is determined by individual clients' preferences. For example, if *'face-to face'* was specified, many clients' schedules are such that it would be impossible to arrange such meetings. It would also be very difficult for meetings to be arranged with clients who are elderly or disabled and who have difficulties travelling, or clients in rural areas who may live far away from the distributors' offices. Similarly, some clients prefer a written communications, (some whom do not wish to receive emails but want a posted letter), whereas other clients prefer a telephone call.

Paragraph 21 states *'For example, it should be specified in the target market if certain acquisition channels may or may not be appropriate to protect the client from precipitance. If online sales were specified as an appropriate acquisition channel, the manufacturer should, for example, make recommendations about "dos" (for example, the amount/quality of information or explanations about the product, warnings, listed product alternatives) and "dont's" (for example, interactive elements such as continuous red and green flashing indicating market price changes*

*may be appropriate for sophisticated clients but may not for less sophisticated clients as they could distract from the main features of the product) of the website where the product is offered or listed.'*

We question the extent to which ESMA is familiar with online distribution channels such as execution only brokers. Many online brokerages will offer thousands of financial instruments. It is impossible to offer specific tailored information for each of the products available online. We fully accept that online distribution channels should ensure relevant information is provided to clients in a manner that is clear fair and not misleading but this must be in the context of an agreed framework having regard to the systems operated by firms. With the Guidelines as drafted, online firms are faced with having to produce bespoke website pages, determined by the manufacturer, for every product they offer; the costs of meeting this obligation would be astronomical.

**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.**

Most of the costs in meeting the obligations in respect of Product Governance stem from MIFID II rather than ESMA's Guidelines. In respect of the provision of information by distributors to manufacturers our firms are concerned about the nature, volume and frequency of requests for non-relevant information in respect of mass market products. We have been unable to ascertain detailed costings from our member firms because they are still uncertain as to how the process will operate. We would refer you to our response to question 8 in respect of the provision of information by execution only brokers.