

Luxembourg, 30th December 2016

**ABBL response to the Draft Guidelines on MiFID II Product Governance
Requirements – Consultation Paper ESMA 2016/1436**

The Luxembourg Bankers' Association ("ABBL") is the professional organisation representing the majority of banks and other financial intermediaries established in Luxembourg. Its purpose lies in defending and fostering the professional interests of its members. As such, it acts as the voice of the whole sector on various matters in both national and international organisations.

The ABBL counts amongst its members universal banks, covered bonds issuing banks, public banks, other professionals of the financial sector ("PSF"), financial service providers and ancillary service providers to the financial industry.

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GENERAL COMMENTS

The ABBL has always been supportive of the proposal to introduce into the MIFID review provisions aiming at avoiding miss-selling given the unfortunate experiences in some EU Members State right after the introduction of MIFID I. Notwithstanding its supports, the ABBL is of the view that investors should be able to choose the best product, which corresponds to its needs, objectives and characteristics, and this in an optimal environment.

Therefore, the ABBL does not oppose the proposition to identify a target market to which a product can be directed and distributed as long as it aims at avoiding miss-selling situations rather than pre-empt and pre-define which products are available to a potential investor, this would at best be override the suitability or appropriateness tests.

It is of utmost importance to underline that each investor is in a different situation, has different objectives, needs and characteristics. Investment is not to be seen as a silo, one-shot action. Investment is built over the years, over needs, over market situations and over evolving financial positions. Investment is about the construction of a portfolio where each product will have a different purpose. Altogether, the products and the portfolio will fill the objective of the investor. Therefore, from this postulate, defining a single target market for one product contravenes to the main objective of investment. One product will not serve the same objective for one investor and for the other.

Following this analysis, the approach to define a target market should be flexible enough to allow investors and their representatives to pick the best products corresponding to their needs.

Hence, the ABBL suggests removing any predetermined principles and to follow the following approach:

Manufacturer level:

- Defining the target market on the basis of the investor category i.e. retail, professional, eligible counterparties and
- Defining the target market on the basis of the legal constraints in the jurisdictions in which the product is registered, in which the investor is located, and allowed or not to invest in a product following regulatory definition.

This dual approach aims to ensure that the concept of miss-selling are respected at the product level. We do not think it is appropriate to do more as we consider that a product is not intrinsically good or bad, but a product may or may not have its place in an investor's portfolio. We propose the following examples: AIF funds some could not be offered to retail investors in some Member States; bonds with a high denomination could only be offered to qualified investors (above the high denomination mark).

We also consider that the definition: at "manufacturer" level should be relatively open, notably because some instruments are accessible in secondary markets where an investment firm has not always a mandate to stop a trade. This is the situation of most equity shares, in the EU and outside. Furthermore, in that particular case, the issuer is often not a professional of the financial sector hence could not be considered as "manufacturer or manager" of its own securities. The definition of a target market applied in these circumstances is very likely to be counterproductive for corporates or others willing to access capital to finance the development of their activities.


Distributor level:

The Distributor should be able to refine, if needed, its target market on the basis of his business model and its groups of investors.

- Defining the target market on the basis of the type of investor's financial situation: retail investor, retail investor who is a private banking investor, high net worth individuals...
- Defining the target market on the basis of the type of investors' strategies (risk averse, growth...).

To add an example: a distributor of financial products may consider that a given bond is principally for "well aware" retail and still find a place in a discretionary portfolio of a risk averse investor but for a low percentage, to benefit from a better risk-return trade-off. To the roots our advice is not to confuse the suitability or appropriateness test with a product test that will pre-empt any future decision.

That is why we are highly concerned by the approach retained by ESMA (in this consultation) and by some other stakeholders. We fear that by pre-empting the risk-reward / distribution category of a product this will obstruct the construction of the most



appropriate or desired portfolio at investor level. To manage legal risk, Investment Firms (IFs) will likely offer products of the “defensive” category to “defensive” investors. However, the constitution of an investor's portfolio should be a mix of instruments so as to ensure the appropriate balance between risks and rewards as suggested by the very basic principles of the portfolio management theory.

We also strongly question the principle of a detailed approach retained as we hardly see how it will interact with the suitability test that will be performed at the end investor level. Indeed, building on the previous comments how will an IF propose an adequate product to an investor if the target market does not equate the risk profile of this investor. In the end, the approach will limit creativity, new products and diversification. As a consequence it will introduce bias in the risk profile of investors' portfolios, not necessarily for the better.

We would equally question the responsibility of the IF when an investor asks to buy a specific product where the target market does not fit the client risk profile (a defensive client buying a few per cents of an AIF, in a jurisdiction where it is authorised). We consider that the IF should not be responsible for the target market adequacy with a potential investor demand. The set up of such a target market should be recommended only when the IF is the one who initiates the offer of products to an investor. We think that this fear would play to the maximum extent when investment firms rely on automated tools (robo-advice). These will likely exclude from the outset some useful instruments with the primary view of lowering potential legal risks, but not necessarily in the interest of the investors.

Therefore, we consider that a two-step approach should be built:

- at the manufacturer level the criteria should be based on “legal” limitations;
- then in a second layer, distributors who know the risk profile of investors, should be able to refine the target market in more granular categories without being hindered in the construction of an investor's portfolio.

DETAILED COMMENTS

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.

Following the general remarks, we do not agree with the list of categories that manufacturers should use as a basis for defining the target market for their products. Though the draft guidelines specifies these categories are not per se new suitability / appropriateness tests; we can't refrain from noticing that the categories correspond to a suitability test and will be used as such in the future to place IF on the safe legal side.

We therefore strongly oppose to such an approach which risks creating:

- More confusion between the target market of the producer and of the distributor,
- Risks pushing out of the market some products (by not allowing to offer a product to some investors with particular needs),
- Situations of legal uncertainty (what about the situation where a retail investor needs, for hedging purpose for example, a product which is not entailed for the retail market?) and finally,
- Uncertainties with regard to current positions as it is not clear what investors should do with the current portfolio.

Should they be forced to sell inadequate positions or are they allowed to keep them, which then would trigger a potential legal risk for the IF.

In light of ESMA's proposal it seems essential to remind the process regarding the product selection for a certain investor. First and foremost, the product is manufactured by a manufacturer, which sets a certain type of investor to whom the product is addressed. These types of investors should be broad enough at this stage, so as to better allow answering the need of each investor. Then, the distributor, by its product governance arrangements, selects the type of products it will distribute to each category of investors. Finally, the distributor addresses the product only to investors who have the need to.

Therefore the process starts by a broad identification of the market to a refined

distribution channel tailored to the need of particular investors.

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.

Despite agreeing on the principle of having a differentiated and proportional approach depending on the types of product we do not consider the approach proposed to take the product's nature into account as appropriate.


The approach proposed in the consultation paper consists of differentiating the products by the level of granularity of the analysis of the six elements mentioned in the points 11-15. However, we strongly oppose to the approach based on the six following elements: type of investor, knowledge and experience, financial situation, risk tolerance, objectives and needs. These elements pertain to the definition of the risk profile and hence the portfolio of an investor, not the definition of a single product. Investors never have a single position (at the very least they have cash exposures).

To differentiate between several types of products, we believe that the six elements should not be mandatory for each manufactured product. We believe that some products can only focus on the investor type (e.g. shares) and that other products that are more complex (such as CFD) should consider additional elements (e.g. need for return, need for diversification, etc.) in the definition of the target market.

Finally, we believe that manufacturers are not able to define as a preamble a scale of acceptance in terms of risk-tolerance as proposed in the consultation paper. Indeed, risk tolerance is evolving, and is specific to each investor. Thus, it should remain in the hand of the CRM or the distributor to define if one product meets the risk tolerance profile of one investor.

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

While the ABBL understands the possibility to apply a more granular method to identify the target market at the distributor level, the proposed method is nevertheless not appropriate.




The ABBL would like to underline the need to differentiate between the three main steps in identifying which product can be sold to which investor. As stated above there are three levels: the manufacturer level, the distributor product governance level and the suitability/appropriateness point of sale level. Each level should go crescent in terms of granularity to identify the targeted investor. As a consequence, there should be differentiation between these levels and the six elements mentioned in the draft guidelines (type of investor, knowledge and experience, financial situation, risk tolerance, objectives and needs) should not all apply jointly. We believe the six elements apply jointly only in the last level, at the end investor. Concretely, a product that is defined as not risky for a retail investor may end up being bought by professionals, eligible counterparties with much higher risk profile, or given specific market circumstances.

The second level (i.e. product governance of the distributor) should concentrate on the following elements: type of investor (retail, professional, eligible counterparts), the type of service (advised, not advised (execution only, with the appropriateness test) and knowledge and experience. Admittedly, the category of investors can be more granular (e.g. legal entity vs. personal retail investors, High Net Worth Individuals). Notwithstanding these elements, it is crucial to ensure the suitability test (financial situation, risk tolerance, objective and needs) is carried out at the last level of point of contact with the end investor so as to ensure to better serve and take into account the investor specificities / situations (seek for diversification, investment, return).

In addition, there are clear contradictions with MiFID II requirements in that approach. The Guidelines considered that the distributors should take into account any data that it deems useful to define target market (paragraph 27). Seen in parallel with the paragraph 36 where it is explained that even in the absence of appropriateness investigations, distributors should look at any data in their possessions to define a target market. This forces distributors providing execution-only service to perform additional analysis (a new kind of appropriateness analysis) when it is not compulsory. Nevertheless, MiFID II clearly provides that for execution-only services there is no appropriateness analysis to be performed.

Finally, it should be underlined that a too strict method in defining a target market may be counterproductive to the objective of protecting investors and stimulating the economy. Indeed while a product may be classified as not corresponding to a retail



investor in general it can in fact be needed for specific retail investor situation. The most classical example would be the one of equity shares or hedging options. They may fluctuate vividly but nevertheless have a lot of meaning for investors (even risk averse ones). In that case, the discrimination will be on the amount invested. Furthermore, investors are not buying products in isolation, they are building investment plans/portfolios, investors have changing needs and objectives and may have different investment plans in line with their life cycle. All in all, they are building a portfolio with different products to balance or better reach their objectives.

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.

Diversification is key for any portfolio type. Therefore, despite agreeing on the principle of portfolio diversification and hedging we do not agree with the suggested approach. In particular:

- Diversification and hedging are inherent to investment, this should not be considered as a “deviation” from a certain target market.
- Considering diversification and hedging as a “deviation” will trigger too much administrative burden to be followed which in turn will restrict proper investment possibilities for investors.
- Target market should therefore be defined in less restrictive terms so as to allow diversification.
- In addition, it could be proposed to add a mention of the diversification /hedging usefulness on each concerned product so that these products can still be proposed to investors having an hedging need/ diversification objective without being spotted as deviating.

Finally, the ABBL would like to see the approach defined in paragraph 34 applying as a general principle (and not only for hedging purposes). Indeed, in order to facilitate the construction of investment portfolios, and not to create legal risks, including several target markets for one product should be the norm.

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?

First of all, the ABBL would like to recall that we strongly oppose to the approach for defining the target market for manufacturers as presented in the draft guidelines.

We understand the need to define a target market for products where manufacturers are not in the scope of MiFID so as to still be allowed to distribute these products. One of the issues is that some products are not “manufactured”. Regarding shares or bonds, for example, the issuer being a State or corporate, how could they define a target market and ensure that it is respected? These instruments are traded on open markets most of the time. Anyhow, this target market should not be as restrictive as it is currently proposed.

In addition, if a distributor defines product governance for products manufactured by entities outside the scope of MiFID the question of how to get a Key Investor Document for such product should be solved. Indeed, without a KID for PRIIPs for example, the distributor will not even define a target market and will not distribute these products.

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

The ABBL is supportive of the idea of a negative target market. Nevertheless the ABBL believes that only one approach should apply: i.e. defining a positive target market or a negative target market, but not both.

In addition, the ABBL would like to recall all the risks associated to having a very strict approach for target markets.

- There is an important legal risk: there are too much legal proceedings risks associated with any deviation of the target market defined in the first instance. Indeed, product manager will impose constraints to the distributors, who will have to impose, in turn, by design of the rule, stricter criteria to let investor access these products.
- There is a risk not to answer properly investment needs of the investor: via the definition of a target market, investors for whom another target market product is

needed may not be offered these “out of the target market product” because the IF will not take the risk to deviate from his category.

- There is a risk to push out of the market too many products; due to the decrease in demand such products will experiment.

Therefore, if another layer is added to the target market, it doubles the risks on the resilience of the investment. Hence, it contravenes to the CMU objectives of stimulating growth, which to be recalled will largely come from investments. Finally, as described in the guidelines, if one deviates from the positive target market toward the negative or grey zone target it will have to document this deviation in depth, which might be counterproductive and costly.

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

The ABBL agrees that when the end-investors are professional investors or eligible counterparties the approach should be adapted. We suggest the approach to be simpler, by simply defining the investor category or by only presenting the objective that the product aims to achieve.

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

We do not think that there are “good and bad” products. There are products that could fit a given portfolio or not, at a given point in time, for a given investor. Generally, the approach to define a target market should allow enough flexibility to be able to sell products to investors who need them. Therefore, we disagree with the six principles defined in paragraph 11 and we suggest using the following criteria as a basis:

- Investor types: retail, professional, eligible counterparties.
- Geographical particularities.