**FECIF Statement**

***(December 2016)***

**on the**

**ESMA Consultation**

**Draft guidelines on MiFID II product governance requirements**

***(5. October 2016, ESMA/2016/1436)***

**General comments:**

FECIF welcomes the main product governance requirements detailed by ESMA, which provide necessary guidance for the daily business of practitioners. However, widespread distribution models in many European countries have not been taken into account. In particular, there seems to be little consideration or understanding of so-called "open architecture" platforms, which offer services to both intermediaries and investment companies, increasingly acting as their technology and product providers. From our point of view, POG needs a consistent approach which takes into account the existing variety of business models and their different characteristics.

MiFID-2 defines the so called “target-market” which has to be taken into account by manufacturers of financial instruments within their product governance process. Distributors are obliged to gather all information about the target-market of each financial product which they intend to offer to their clients, the consumers. Based on this very concept ESMA´s draft introduces another plan of a so called “distribution strategy” which was not the one intended in the level 1 text. Following ESMA´s deliberations manufacturers of financial instruments in addition to defining “target-markets” also need to define “distribution strategies” and distributors need to gather all information about the distribution strategy of each financial product which they intend to offer to their clients, the consumers. ESMA is obviously assuming that there is always a direct relationship between manufacturers and distributors, concluding that distributors always enter into direct agreements with the respective manufacturers. However, this is not the case.

In many European member states the most common business models of cooperation between manufacturers and distributors are via “open-architecture” platforms.

Such platforms are independent companies offering all kinds of infrastructure for ordering (buying/selling) financial instruments and managing securities deposits for clients. Some platform companies are even affiliates of investment firms or asset managers. Platforms usually cooperate with hundreds or even thousands of different manufacturers and with hundreds or even thousands of distributors, all at the same time. Distributors which are MiFID-2 regulated entities (investment firms) contract with open-architecture platforms to become entitled to offer the whole range of financial instruments available on a platform, to their clients. The distributors themselves are either employing sales-staff or cooperating with self-employed sales-agents who act at the point of sale by using the technology of the open-architecture platform as well as the infrastructure of the investment firm to advise clients, to order their financial instruments and to constantly administrate their portfolios.

From what has just been described, it is apparent that the concept of “distribution strategy” introduced by ESMA would never work within the world of open-architecture. Neither are distributors capable of permanently overseeing such strategies for hundreds or even thousands of financial instruments on a regular basis, nor would manufacturers be able to foresee the individual distribution strategies of hundreds or even thousands of distributors and their sales agents who are totally unknown to them as they are solely contracting with the open-architecture platform and never have any direct interaction at all. This is also why level 1 and 2 explicitly require distributors to take into account the **target-market** of each financial product they intend to offer to their clients. ESMA should not do more or less than staying with the target market concept and neither soften it nor make its implementation impracticable. We therefore ask for the deletion of the concept of “distribution strategy” within the whole guidelines. Distributors need to know the target market and it is their job by nature to implement this into their individual sales channels.

Another point of concern of FECIF members is the **date of entry** of the target market. ESMA defines in their draft guidelines the 3rd of January, 2018 as the absolutely binding deadline for distributors, but not for manufacturers. In fact, manufacturers should assign target markets following the next product review process cycle that is conducted according to Article 16(3) after the 3rd of January, 2018. For the period between 3rd of January, 2018 and the undefined date on which the manufacturers will have defined a definitive target market for their products the sole responsibility of defining target-markets would be transferred to the distributor who should act as if the manufacturer was an entity not subject to MiFID-2 product governance requirements. Such an approach for MiFID-2 regulated entities would be practically impossible!

What if the distributor defines a target market and the manufacturer determines a different target market sometime later? Was the distributor then advising inappropriately? From a retrospective viewpoint? Do the advertised customers automatically have a right of cancellation? Does the distributor have full liability retroactively because it has not sold in line with the target-market? Has the management of the distributor been guilty because a future risk was not sufficiently disclosed to the customer? Or, should the distributor tell the customer from the very beginning that they believe they have correctly identified the appropriate target market, but do not know for sure whether the manufacturer will determine the same target market or another, sometime later?

The target market concept is the central hub of the entire MiFID-2 product governance initiative and can only work with clear guidelines from the manufacturers' side. Simply, for reasons of liability, no manager of any MiFID-2 regulated company will sell products without a clear target market definition. It is therefore essential that distributors and manufacturers together operate from the same introduction date.

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

We consider that *category* (a) “The type of clients to whom the product is targeted”represents the first basic step, underpinning all the other categories. Concerning client categorisation pursuant to MiFID II, we think that the crucial distinction is between retail and non-retail clients. With regard to additional descriptions commonly used in the market, we point out that client categorisation by means of *«additional descriptions commonly used in the respective market»* may create a risk of confusion: comparability could be hindered because each firm would use its own categorisation. A possible solution, ensuring comparability and clarity towards both market players and clients, may be envisaged if international clustering standards are considered as, for example, *high net worth individuals* (HNWI), *affluent clients* and *retail market*. This categorisation would enable market operators to classify clients according to their financial situation, thereby readily clarifying the types of services and products they may have access to.

Categories (b), (c) and (d) are intimately interlinked.

We fully agree that the two pillars of category (b), “knowledge and experience”, may depend on each other in some cases. It is vital that an investor with limited or no experience could be a valid target client if he compensates missing experience with knowledge (this is already the case in some Member States, for instance Germany). Otherwise, there is the risk that no new client could be considered as a “client with experience” (let’s consider the case of a young professional with a master’s degree in Economic & Finance).

The category (c) “ability to bear losses” may be understood by means of a technical measure of downside risk (for instance, the Ulcer Index).

As for category (d) we point out that risk tolerance refers to the risk-attitude of the client: in this sense, risk tolerance is client-focused and should not be confused with the risk/reward profile of the product. Further clarity is also needed to ensure consistency between the synthetic risk indicator stipulated by the PRIIPs Regulation and the categorisation, commonly used in the market, based on risk-attitudes (cf. also client profiling pursuant to the assessment of appropriateness and suitability as prescribed by MiFID II). On the one hand, the PRIIPs Regulation requires a classification of the product as [1/2/3/4/5/6/7] out of 7, each class corresponding to a risk level ranging from “very low” to “very high”. On the other hand, the categorisation commonly used in the market is based on five portfolio types (i.e. “stable/prudent”, “conservative”, “balanced”, “income” and “dynamic/speculative”). This could create a problem of mismatching, as the PRIIPs Regulation entails seven risk classes, while five portfolio types are commonly used in the market: a specific and clear regulatory guidance is thus needed in order to clarify how risk classes should be declined in terms of portfolio types. Such guidance would also be useful for financial advisors, considering their role in assisting clients so as to understand their risk-attitude and choose suitable products.

As for category (f) “client’s needs” we do not agree with the distinction between “specific” and “generic” needs: conversely, we propose a distinction between needs of a “technical nature” (pertaining to product features and contents) and the needs relating to the personal situation of the individual (e.g. age, family needs …). In any case, the focus should be on the clients and their needs.

**Q2: Do you agree with the approach proposed in paragraphs 18-20 of the draft guide-lines on how to take the products’ nature into account? If not, please explain what changes should be made and why.**

Concerning the nature of the product, we agree with paragraph 17, page 7, of the Consultation Paper (« For more complicated products, such as CFDs or structured products with complicated return profiles, the target market should be identified in more detail. ») and we also quote MiFID II Delegated Directive, Recital (19), which clarifies that « for more complicated products such as bail-in able instruments or less common products, the target market should be identified with more detail ». Both provisions confirm the need to exclude the execution-only regime: i.e., for these products the assessment of appropriateness or suitability shall always be required.

More generally, we believe that there is no actual need for an execution-only regime with regard to online sales: a MiFID investor-questionnaire to assess client’s knowledge and experience (appropriateness assessment) may be easily structured and presented with an online form. That is to say, a mandatory appropriateness assessment for all online sales is a desirable solution, because it ensures more investor protection and is easy to implement. At the same time, we believe that online tools for the assessment of appropriateness should be designed so as to avoid the risk of a kind of self-profiling by the user that, by trial, may complete the automated procedure, in order to obtain a specific product, without an effective evaluation of the appropriateness of the choice.

Besides, we propose amendments to paragraph 18, page 24, of the Consultation Paper as follows:

*“This means that the target market identification should consider the characteristics of the products including complexity (including costs and charges structure), risk-reward profile ~~or~~ and liquidity, ~~or~~ and the innovative character of the product”.*

This amendment is needed to clarify that these characteristics should be considered in a cumulative (and not alternative) way.

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

With regard to the list of categories that distributors should use as a basis for defining the target market, please see our answer to Q1.

Commenting on the final statement of paragraph 26, page 25, of the Consultation Paper (« … the distributor could decide that some non-complex products which could potentially be offered under the execution-only regime will only be offered in accordance with appropriateness or suitability requirements, so as to grant a higher degree of protection to clients ») we would like to point out that some EU Member States already have in place such provisions for the sales of insurance- based investment products. For example, regulation in Italy excludes the execution-only regime for financial products issued by insurance companies: cf. Consob Regulation no. 16190/2007, whereby Article 87 does not apply the provisions on execution-only (Articles 43 and 44) to financial insurance products. In such country-cases, it seems likely that this concept will be taken into account for MiFID-2, too. If ESMA decides to leave the choice of how to offer non-complex products to the distributor (i.e. with or without appropriateness or a suitability test) this will require a harmonised legal transposition of MiFID-2 by the European Member States including a harmonisation of the sales of insurance based investment products with all other types of financial instruments. Otherwise ESMA´s guideline would contradict with existing or still- to-come national provisions and/or open loopholes for arbitrage between the Member States and between different investment products even on a national level.

In our opinion the assessment of appropriateness or suitability (cf. MiFID) needs to be always required, thereby providing for an effective standard of investor protection.

We do not agree with paragraph 42, page 29 of the Consultation Paper: if we acknowledge that « the client’s protection decreases when information available is not sufficient to ensure a full target market assessment » we cannot accept that distributors may decide « to let clients operate on a non-advised basis after having warned them that the firm is not in the position to assess their full compatibility with such products ». We believe that such a warning is not sufficient: the solution envisaged is thus extremely detrimental to investor protection, in that it would lead to the distribution of products which are not compatible with clients’ needs, characteristics and objectives.

Finally, we agree with paragraph 48, page 30, of the Consultation Paper. Indeed, pursuant to recital 20, MiFID II Delegated Directive, « distributors should periodically inform the manufacturers about their experience with the products. While distributors should not be required to report every sale to manufacturers, they should provide the data that is necessary for the manufacturer to review the product and check that it remains consistent with the needs, characteristics and objectives of the target market defined by the manufacturer. ». Building on recital 20, paragraph 48 of the Consultation Paper clarifies that « Such information may be in an aggregated form and does not need to be on an instrument-by-instrument or sales-by-sales basis. »: we consider that this clarification strikes an effective balance between the efficient functioning of product governance obligations and the need to avoid unnecessary administrative burdens on distributors or potential risks with regards to privacy for investors.

**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.**

In paragraph 34, pages 10-11, of the Consultation Paper, one crucial point is missing: in addition to the situations whereby the clients already have adequate knowledge and understanding of the product (“ex ante or in-going knowledge”), the same product (an Interest Rate Swap, in the example) may also be considered for the distribution to clients whose needs may indeed be met by means of this product, although such clients do not have, at first, knowledge of it. In this situation, the role of financial advisors is of paramount importance: it is up to the advisor to understand the needs of the client, identify the suitable/appropriate products, and help the investor to understand the product (in this case, the required knowledge of the product is thus acquired in the course of the interaction with the financial advisor).

Against this background, we ask to modify the entry section of paragraph 32 (page 10) according to which “These situations … should not occur on a regular basis.” Indeed, it would be expected that, if the suitability assessment is correctly conducted, recommending products outside the target market, if based on the consideration of the specific client’s features, will be meaningful and permissible. Of course, firms should avoid distributing products outside the target market in cases where there are significant conflicts of interest but such provisions have to be taken into account, anyway, in the conflicts-of-interest regime and COI policy by the compliance management. The entry section of paragraph 32 therefore should simply refer as follows. “These situations above should be justified by the individual facts of the case.”

**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?**

No, it is not. The guidance provided in the Consultation Paper is clear and comprehensive.

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

We fully agree with the proposed positive and negative approach with one possible additional area in between. This allows deviations for sale outside the positive target market with substantial justifications.

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

We agree with paragraph 21, page 8, of the Consultation Paper, i.e. « it should be specified in the target market if certain channels may or may not be appropriate to protect the client from precipitance. ». In this sense, we believe that both manufacturers and distributors shall be mindful that clients are not protected at all in the case of execution-only online sales (paragraph 40, page 28, of the Consultation Paper). In this sense, we think that non-advised sales should be limited to simple, more common and easy-to-understand products.

We point out the potential detrimental effect of the situation outlined in paragraph 46, page 29, of the Consultation Paper (« For example, if the manufacturer deems that a given product, due to its specific features, should be offered to clients through the provision of investment advice, the distributor could still make that product available through execution services to a specific segment of clients. »): the case under paragraph 46, indeed, seems to contradict the statement under paragraph 38 (« In particular, investment advice and portfolio management services allow for a higher degree of investor protection (through the application of the suitability rule), compared to other services provided under the appropriateness regime or under execution-only. »). That is to say, in cases where the manufacturer deems that the product should be offered to clients through the provision of investment advice, the distributor should not revert to non-advised sales thus sacrificing the objective of “enhancing the level of protection of investors” which underpins all product governance obligations (paragraph 1, page 4, of the Consultation Paper).

The same reasoning applies to Example 2 - Structured deposit product target market case study (page 39, of the Consultation Paper « In light of the target market analysis, the product can be promoted with or without advice, with no additional requirements or restrictions on distributors. »). The objective of “enhancing the level of protection of investors” may be better served through the provision of investment advice, increasing proportionally to the complexity of the product: from this point of view, sales without advice should be permitted, although they should not be considered as an equivalent alternative to advised sales.

**About FECIF**

The **European Federation of Financial Advisers and Financial Intermediaries** (FECIF) was chartered in June 1999 for the defence and promotion of the role of financial advisers and intermediaries in Europe.

FECIF is an independent and non-profit-making organisation exclusively at the service of its financial adviser and intermediary members, who are from the 28 European Union member states, plus Switzerland; it is the only European body representing European financial advisers and intermediaries. FECIF is based in Brussels, at the heart of Europe.

The European financial adviser and intermediary community is made up of approximately 500,000 private individuals exercising this profession as a main occupation (representing approximately 26,000 legal entities including 45 networks), about 280,000 are members of national professional associations (51 at today’s count).