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Via website upload
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Response of the Deutscher Derivate Verband (DDV) to ESMA's Consultation Paper - Draft guidelines on MiFID II product governance requirements as of 5 October 2016

Ref.: ESMA/2016/1436

Dear Sir or Madam,

The DDV welcomes the opportunity to answer to ESMA's Consultation Paper in relation to draft guidelines on MiFID II product governance requirements as of 5 October 2016 (ESMA/2016/1436) ("**CP**"). In particular, we would like to share our views on the draft guidelines as set out in section 3.3 Annex 3 of the CP ("**Draft Guidelines**").

Part 1: General comments

Since directive 2014/65/EU ("**MiFID II**") came into force, the DDV and its members have been closely observing all developments in the area of product governance. We support the legislator's intention to introduce obligations for manufacturers and distributors in connection with the creation, design and development of financial instruments, including the determination of target markets as well as the review of products and their distribution in order to ensure a higher level of investor protection. However, we are deeply concerned that the suggested Draft Guidelines go beyond MiFID II Level 1 and 2 requirements and may lead to disproportionate burdens for manufacturers and distributors of structured products. As a consequence, existing market structures for the distribution of structured products in certain European markets, including Germany, may in future be jeopardised, or at least be in question. In our view this is contrary to the intention of the EU legislator. For good reasons the EU legislator has chosen on both, Level 1 and Level 2, the instruments of a directive (and not a regulation), to give Member States some room for discretion and the opportunity to recognise particularities of certain markets and jurisdictions.

Our concerns are mainly related to the following issues:

We think it is not appropriate to restrict the distribution of structured products to distribution through investment advice only.

We welcome that ESMA is stressing the importance of the general principles of appropriateness and proportionality in the context of product governance requirements, but we are concerned by ESMA's statement that investment advice and portfolio management services allow for a higher degree of investor protection, compared to other services provided under the appropriateness regime or under the execution only regime. The statement does not acknowledge the nature of different clients and their needs as well as the nature of different products and may lead to unnecessary restrictions of distribution of certain products in practice. In Germany, it is quite common that structured products are accessible to retail investors via online brokerage services. Most of the investors who use the online brokerage execution services (i.e. "with appropriateness test" or "via execution only") are sophisticated investors and do not require and also do not wish to receive any investment advice. This is by far the biggest distribution channel for structured products in Germany. An important distinction has to be made here between the complexity and the risks of a structured product. While there may be an argument that for complex products additional considerations as regards appropriate distribution channels are required it must continue to be possible for investors to buy products which are more risky (e.g. warrants with a leverage factor), but also provide chances of higher returns. As BaFin will be able to confirm, in past years that market segment has not given rise to a significant number of complaints by retail clients. Pursuing the approach suggested by ESMA could end up completely shutting down this market segment and creating an indirect product ban what is certainly not in the interest of investors. It strongly has to be emphasized that MIFID II does not provide the framework for such an indirect product ban to be implemented on Level 3.

An over granular target market definition is not practicable. Standardisation of target market criteria is key in order to allow automation and third party distribution - an essential element of an open and competitive financial market architecture.

We would like to point out that by defining target market criteria in a manner which is too granular, the access of investors to a wide range of products may be limited. Standardisation and automation are key in order to establish processes which allow the efficient functioning of the distribution of financial instruments in the wider market space with different distributors and thus promoting competition. In practice, IT-interfaces between manufacturers and distributors are indispensable in order to match the criteria used. Using a higher degree of granularity, in particular when using terms not defined by law or not standard in the market, would prevent firms from using automation. If a manufacturer defines the target market too granular, distributors lacking respective information about their clients will not be in a position to match these clients to the defined target market. In practice, this may hinder the sale of products of third parties. Limiting the number and range of products available to clients contradicts the overall aim of MiFID II to give clients access to a wide range of products, including products from third party product providers. Limiting the range of products would also harm the existing open architecture of financial instruments and hurt competition.

Part 2: Responses to ESMA's questions

Where appropriate we made reference to the Draft Guidelines as included in Annex III of the CP.

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.

We generally agree to the list of categories (as described under paragraph 16 of the Draft Guidelines) that manufacturers should use as basis for defining the target market. However, as pointed out in our general remarks we are concerned about the level of granularity as further pointed out in the following.

Each of the following bullets mirrors one of the six categories which ESMA has proposed:

- The type of clients to whom the product is targeted (paragraph 16(a) of the Draft Guidelines)

  We agree that the manufacturer should specify the type of clients targeted. As already required by Level 1 and Level 2 legislation this should be done by using the MiFID II client categorisation, i.e. specifying whether the client should be a "retail client", a "professional client" and/or an "eligible counterparty". We generally agree with such approach. We note that ESMA proposes that "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."

  Standardised criteria for the industry are required to make the target market work. This is particularly important in order to ensure that distributors can compare the manufactured products. Currently, there are no common and uniform criteria in the industry that could be used for the proposed refinement, at least not in Germany. We ask ESMA not to encourage single manufacturers to develop and use their own criteria in order to refine the client categorisation for purposes of the target market.

- Knowledge and experience (paragraph 16(b) of the Draft Guidelines)

  The DDV does not agree with ESMA's proposal as regards granularity of the category "knowledge and experience".

  Level of granularity

  We think it is important to stipulate uniform sub-categories applicable for all manufacturers and distributors in order to allow manufacturers and distributors to utilise this category. Again, introducing a regime that allows the use of different terms and

descriptions for the same subject, will negatively affect the functioning of automation and comparability of the products. We are convinced that a strictly limited number of sub-categories representing different levels of knowledge and experience would sufficiently transpose the requirement whilst also maintaining a sufficient level of practicability.

No obligation for distributors to collect additional information

It should be considered also that any additional specification as regards knowledge and experience could require data gathering by the distributor, if the distributor would actually be forced to have available information in relation to each criterion or sub-criterion of the target market defined by the manufacturer. In practice, collection of information in relation to each criterion and sub-criterion could be very difficult, because clients tend to not cooperate in such a process for various reasons, including concerns about data protection. We are of the opinion that distributors shall not be forced to collect additional data (in addition to the data already collected under the suitability and appropriateness regimes) as a result of a more granular definition of the criterion "knowledge and experience".

Distinction from the appropriateness and suitability checks required

Furthermore, we would like to note that the introduction of detailed sub-categories in this category would lead to requirements at the level of the manufacturer similar to those which apply for suitability and appropriateness test at the level of a distributor. According to recital 71 of MiFID II product governance obligations "should apply without prejudice to any assessment of appropriateness or suitability to be subsequently carried out by the investment firm in the provision of investment services to each client, on the basis of their personal needs, characteristics and objectives". It is our understanding that this means that product governance on the one hand and suitability and appropriateness checks on the other hand shall be regarded as two separate processes. It would be disproportionate to apply very granular criteria on the level of the product manufacturer. This applies even more because performing such extensive checks on the level of the manufacturer would make the respective check on the level of the distributor (i.e. assessment of appropriateness or suitability to be subsequently carried out by the investment firm in the provision of investment services) meaningless.

Knowledge may substitute experience (and vice versa)

ESMA is of the view that "knowledge and experience may be dependent on each other in some cases" (last sentence of paragraph 16(b) of the Draft Guidelines). We agree that the categories of knowledge and experience always have to be seen in connection with each other. Sufficient knowledge may outweigh lack of experience and sufficient experience may outweigh lack of

knowledge. More generally speaking, it is important that the client has sufficient understanding of the product regardless of the way the client has gained such understanding. Self-evidently, a requirement for a certain degree of experience as regards a certain product or product type would ultimately make it impossible for a client to invest into products which are new to him or the market generally.

Accordingly, it is our understanding that the expression "in some cases" as used by ESMA in paragraph 16(b) of the Draft Guidelines may not be understood in the way as if there was a general rule requiring both, knowledge and experience, at the same time. We suggest revising the introductory wording in paragraph 16(b) of the Draft Guidelines to "knowledge and**/or** experience".

- Financial situation with a focus on the ability to bear losses (paragraph 16(c) of the Draft Guidelines)

  We note that ESMA would like to express the potential losses a target market client should be able or willing to suffer as "a maximum proportion of net investable assets that should be invested". We find it difficult to understand how this could be applied in practice. In addition, e.g. for structured products this does not provide additional information as there are no margin calls thinkable. As a general view, we would prefer to keep the information included in the target market concept as simple as possible.

  Another consideration that should be taken into account in this context is that the financial situation of a client is not only defined by its net assets, but also by the sum of the overall assets the client is in possession of, e.g. real estate properties, company shares and securities. Focusing solely on net assets would distort the view on the financial situation of the client. Consequently, the financial situation of the respective investor depends on multiple criteria which make it very difficult for the manufacturer to make any assessments.

  We therefore ask ESMA to delete the inclusion of any reference to the proportion of net investable assets.

- Risk tolerance and compatibility of the risk/reward profile of the product with the target market (paragraph 16(d) of the Draft Guidelines)

  We agree that this category is important. However, as regards the presentation of the risk attitude we are of the view that using a number as foreseen by the PRIIPs Regulation (i.e. from 1 to 7) for PRIIPs products and in a similar, more simple way also for non-PRIIPs products would be sufficient and offers the advantage that it will be uniformly applied across the industry once the PRIIPs Regulation becomes applicable. Using a detailed narrative to present the risk attitude of the proposed clients would have counterproductive effects: Such narrative may differ from

manufacturer to manufacturer and distributor to distributor. This is definitively true for Germany and we assume that such descriptions further differ across Europe. Using numbers only as a measure for the risk attitude would be much more comprehensible for all parties involved to understand the real level of risk. We understand from the European Commission's "Consumer testing study of the possible new format and content for retail disclosures of packaged retail and insurance-based investment products" performed in relation to the PRIIPs Regulation that the simple scale from 1 to 7 is the best way to communicate the risk inherent to a product.

- Clients' Objectives (paragraph 16(e) of the Draft Guidelines)

  We generally agree with this category and its description in the Draft Guidelines. We understand that the category "Clients' Objectives" would in particular cover the sub-criteria "investment objectives" and "investment horizon". In order to ensure functioning of the interaction between manufacturers and distributors and to ensure comparability of the products across Europe we would propose to limit any sub-criteria to those criteria set out in the concept, or, at least to limit the list of any sub-criteria and to predefine these in the Guidelines.

- Clients' Needs (paragraph 16(f) of the Draft Guidelines)

  The category "Clients' Needs" addresses particular needs, which may additionally apply. It is our understanding that such needs do not necessarily need to be mentioned in a target market description, if there are no such particular needs. For example, in the case of a "plain vanilla" bonus certificate, there is usually no particular ethical or green component. Furthermore, it is not targeted towards clients of a particular age or a country of tax residence and does not offer a currency protection. Consequently, we would assume that no such need is to be specified when defining the target market for the product. As this category may be left blank in a target market description, we would propose to consider the needs as optional elements of the category "Client's Objective" and to delete the category "Clients' Needs".

  In addition to the above, it is to be noted that the use of further criteria does not provide for such advantages as are intended by ESMA. The mentioned examples and other criteria of such kind do not provide for reliable information for any market participant or investor as these terms are not defined. Good examples are the criteria "green investment" and "ethical investment". There is no common definition of what a green or ethical investment needs to adhere to. Manufactures would have to decide by themselves if they consider a product to comply with "green" or "ethic" criteria and there wouldn't be any industry standards as to which these terms could be matched. Hence, we are convinced that such additional criteria are not suitable criteria for a reasonable differentiation.

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.

- Approach how to take the products' nature into account (paragraphs 18 to 20 of the Draft Guidelines)

  We generally agree with the approach. However, in our view the description under paragraphs 18-20 of the Draft Guidelines does not sufficiently state in a clear manner that firms may also use a common approach to assess target market criteria. A certain level of harmonisation is essential in order to avoid unnecessary burdens for manufacturers which intend to design a broad range of products for the market. In our view, this is an important and critical point. When a manufacturer produces products for the mass retail market, e.g. structured products, the manufacturer often produces a large number of products containing similar or identical features (e.g. pay-off structure), but such products may differ in certain details. As it would not be possible to conduct a target market assessment in each single case each time, it should be possible to allocate certain issuances of products to product types that already went through the required approval procedures.

  Absent a possibility to define target markets for product types, it would be nearly impossible to provide the range of products that is required in order to offer to investors such products that can fit to the then prevailing market conditions.

  The DDV therefore strongly recommends to directly include a statement into the Draft Guidelines clarifying that assessments may be based on product types and that it is in particular not required to perform a product approval procedure and a target market assessment in relation to each issuance of product of the same type.

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

- Timing and relationship between the target market assessment by the distributor with other product governance processes (paragraphs 23 to 28 of the Draft Guidelines)

  We generally understand ESMA's position requiring distributors to focus on general consistency of the products to be offered and the related services to be provided. In particular, ESMA requires distributors to put a particular focus on the investment services through which the products will be offered to their respective target markets and expects that particular attention is paid to those products characterised by complexity/risk features or by other relevant features (paragraph 26 of the Draft Guidelines). In addition, ESMA's approach requires distributors to decide which products are going to be recommended and which products will be made

available to clients at their own initiative through execution services (paragraph 27 of the Draft Guidelines). All in all, ESMA seems to prefer the distribution of more complex products and products with greater risks only by means of advised investment services (i.e. "investment advice" or "portfolio management" services), rather than by non-advised services (i.e. via "execution only" services or services providing for an "appropriateness test" only). As already stated in our general remarks, we are very concerned by this approach. As a consequence, distribution of structured products may be significantly restricted in the future compared to current practice in Germany as well as in a number of other EU Member States (i.e. France, Italy, Spain or Sweden).

No automatic dependency between the nature of a product and the distribution service

In our view there should be no automatic dependency between the nature of a product (or its complexity/risks) and the investment service that would be most appropriate for a client. We are not aware of any empiric research that has proven such dependency so far. In Germany it is common that structured products are accessible to retail investors via online brokerage execution services. Most of those clients are sophisticated and do not require and also do not wish to receive any advice. Furthermore, most banks in Germany do not even offer a distribution of most of such structured products through investment advice. As BaFin will be able to confirm, in past years that market segment has generally not given rise to a significant number of complaints by retail clients.

Differentiation between complexity and risk features

We are of the view that differentiation between complexity and risk is needed:

Complexity refers to the structure of the product and its features and questions the comprehensibility of the product from the perspective of investors – investor protection is important in this case. In our view, complexity of products is addressed by the criterion "knowledge and experience" of the target market. Clients having sufficient knowledge and experience for the respective class or type of product should be able to purchase complex products. As knowledge and experience is also a part of the tests performed under the appropriateness regime, we see no reason why such product may not be sold on a non-advised basis.

Risk addresses the likelihood of a loss of capital – investor protection is also important in this case, but is subject to transparency of the risks and the decision of the investor to make an investment or not. From our view a client may decide on its own which risk may be tolerable.

Consequently, there is no reason to prohibit investors to purchase products with higher risks, if, in case of a complex product, the investor is able to understand the product.

- Identification of the target market by the distributor: categories to be considered (paragraph 30 et seqq. of the Draft Guidelines)

  ESMA requires distributors to apply the same list of categories as the manufacturer as a basis for defining the target market (paragraph 30 of the Draft Guidelines). The DDV welcomes the basic approach as the use of identical terms and definitions improves the ability of firms to interact with each other. Where the manufacturers and distributors have the same understanding of the categories when exchanging information, this also improves protection for clients.

  However, we note that ESMA also intends to require distributors to perform a thorough analysis of the characteristics of their client base (paragraph 33 of the Draft Guidelines) and to refine the target market (on a more concrete level). In line with our answer under Q1 above, we are of the view that (also in this case) further specification will lead to inconsistent approaches across the market as market participants would need to develop very specific approaches depending on their individual client bases. This may have a material negative effect on the functioning of the interactions between manufacturers and distributors.

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.

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?

- Product manufacturers not subject to MiFID II product governance requirements (paragraphs 51 et seqq. of the Draft Guidelines)

  We want to emphasize that the "manufacturer" is not in all cases identical to the "issuer" of structured products. Level 1 and 2 do not require their identity, either, see definition of manufacturer in paragraph 6 of the Draft Guidelines, too. In case of cooperation agreements within groups it is common that products are issued by special purpose vehicles or other entities (not subject to MiFID II) while the structuring and other components of the structured product are provided by other entities which take over the responsibility as product manufacturer. For this reason, the Guidelines should make clear that the distributor's obligation to define the target market is applicable only in case of structured products for which no entity is to be qualified as manufacturer. Typically, in situations mentioned

above, the entity underwriting or placing the products issued by a firm not subject to MiFID II will have to fulfil the obligations as manufacturer and can deliver appropriate target market information (see also recital 15 of Commission Delegated Directive of 7 April 2016 (C(2016) 2031 final)).

So, paragraph 52 should read:

"Where a product has not been designed in accordance with the MiFID II product governance **requirements (in particular if no entity is to be qualified as product manufacturer)** ~~(for example, in the case of investment products issued by entities that are not subject to the MiFID II product governance requirements)~~, this may affect the information gathering process or the target market identification:"

In paragraph 6, the definition of manufacturer should be clarified as follows:

" 'Manufacturer' means, in accordance with Recital 15 and Article 9(1) of the MiFID II Delegated Directive, a firm that manufactures an investment product, including the creation, development, issuance or design of that product, including when advising corporate issuers on the launch of a new product**. In case of more than one entity involved in the creation and launch of such product an entity involved may assume the whole responsibility as manufacturer. In case of products issued by a group entity not subject to the MiFID II product governance requirements, but structured, underwritten or placed by another group entity subject to the MiFID II requirements, the latter will be qualified as manufacturer. Distributors may rely on information provided by such manufacturers.**"

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

- Identification of the 'negative' target market and sales outside the positive target market (paragraphs 58 et seqq. of the Draft Guidelines)

  We refer to the statements made by ESMA in paragraphs 58 et seqq. of the Draft Guidelines. We do not fully agree with ESMA's approach to define the negative target market. In paragraph 59 ESMA considers that where a positive target market has been stipulated there will be automatically opposing characteristics for investors for whom the product is not compatible and that a firm could define the negative target market by stating that the product is incompatible for clients being outside the positive target market.

  From our view there is no advantage in expressing one and the same thing by positive criteria on the one hand and mirroring negative

criteria on the other hand. There wouldn't be any additional information for distributors or clients resulting from the stipulation of the negative target market. The description of the target market (positive and negative) should not only express exactly the same twice.

This said, the negative target market criteria may be useful in situations where a negative criterion provides for additional information not comprised in the definition of the positive target, i.e. the negative target market definition is not only mirroring the positive target market definition. This should be acceptable in particular in those cases in which the positive target market definition is less prescriptive. However, where the manufacturer has not explicitly defined a negative target market, sales outside the positive target market must not be deemed as sales in the negative target market but as sales in a "grey area".

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

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

- Articulation of the distribution strategy of the manufacturer and its definition of the target market (paragraphs 21 and 22 of the Draft Guidelines)

  We refer to the statements made by ESMA in paragraphs 21 et seq. of the Draft Guidelines as well as to paragraph 8 of the case study 1 (as set out in Annex 4). The requirements set out in MiFID II and the delegated directive supplementing MiFID II with regard to product governance require the manufacturer to define a distribution strategy in relation to a product.

  ESMA is considering that beyond the distribution strategy a choice should be made as regards (i) the investment service that is to be used by the distributor and (ii) the acquisition channel for the distribution of the manufactured product. We believe that this goes beyond Level 1 and Level 2, in particular in relation to the following aspects:

  Investment advice is not the only investment service suitable for products characterised by complexity/risk features

  In case study 1, ESMA expresses the view that investment advice may be the investment service which is most appropriate when structured products are sold to retail clients. ESMA assumes that investment advice could be most suitable in order to evaluate whether or not a client fits into the target market.

  Such an approach would mean that in case of products characterised by complexity/risk features, distribution could only take place

through investment advice as the only permissible investment service for a distribution. There is no objective reason to assume that only the investment service investment advice would lead to the best result for a retail investor. As stated above in Germany, a broad range of online banks make financial products (including structured products) accessible to clients via execution services without advice. Those clients make their own investment decision. These clients also prefer to have no interaction with any advisor of the bank/investment firm when concluding transactions in financial instruments. Excluding these clients by introducing the requirement of mandatory investment advice via the target market definition will deny those clients access to a broad range of services and financial products. Also, offering investors a choice as regards distribution channels is desirable, as it enhances competition among the variety of distribution channels that already exist today. Any limitation of distribution channels may instead violate fundamental rights of these clients and also of manufacturers and distributors.

Once again, we would like to stress that the suggestion that the sale of more complex products and products providing for greater risks should only take place via advised sales and that distributors are required to have detailed knowledge about the clients knowledge and experience before distributing a product (even if they usually provide services free of advice) may have the effect of a "product ban" for more complex products and products providing for greater risks. This is based on the fact that a lot of structured products in Germany are sold only via non-advised services.

In the subsection "*Differentiation between complexity and risk features*" under Q3 above, we have already laid down that we are of the view that it is necessary to differentiate between complexity and risk when it is to be decided which investment services are permitted for distributors. As manufacturers are the first in the chain to define the investment services permissible for distribution, the same considerations apply to manufacturers. Given the significant intervention, at the very least a differentiation between complexity and risk is needed in order to comply with the legal principle of proportionality. Please refer to the respective explanations above. From our perspective there is no need to protect investors from a product providing for greater risks, if the risks are made transparent and the investor is willing to take such risks.

We strongly recommend ESMA reconsiders its approach, which might lead to a massive disruption of current distribution practices to the detriment of customers.

Acquisition channels are to be designed by distributors, not by manufacturers

ESMA is of the view that the manufacturer should specify the "specific design of the acquisition channel".

There is no advantage, if the manufacturer suggests a specific design of an acquisition channel to be used by the distributor. Distributors know much better their clients and which products are suitable for them. In addition, the acquisition channel needs to be fit for products of different manufacturers. In practice, the distributors' business model does not take into account the suggestions of different manufacturers and the permanent re-design of the acquisition channel. Lastly it should not be the manufacturer who takes responsibility for matters which are properly the responsibility of the distributor. In our view, this would go far beyond the requirements of MiFID II and infringe fundamental rights of manufacturers.

We strongly urge ESMA not to take such position and in particular not to apply this to all structured products.

We remain at your disposal to discuss these matters further.

Yours sincerely,

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