Comments by INVERCO on the ESMA Consultation Document on the Guidelines on Product Governance Requirements [ESMA / 2016/1436]

A. GENERAL COMMENTS

INVERCO[1] welcomes these Guidelines insofar as their purpose is to ensure a common, uniform and consistent application throughout the European Union of the product governance requirements set out in MiFID II, in particular, those relating to target market.

In general this is a "balanced" document, but it is also true, as will be indicated later in the answers to the questions, that it is necessary to improve and qualify a significant part of the aspects that are dealt with in this document for the purpose, among others, of ensuring a clear distinction between the responsibility and the capabilities of the manufacturer and the distributor, as well as a clear distinction between the target market of the product (which corresponds to the manufacturer) and the suitability and/or convenience of the product for a particular customer (corresponding to the distributor).

On the other hand, it is necessary to point out that the document is mainly oriented towards complex products, and therefore INVERCO, as an association representing the Spanish Collective Investment Schemes, found it necessary for the Guidelines to specifically address the treatment of the target market for non-complex products targeted to the mass retail market, as is the case with shares or/and units of non-complex UCITS, or AIF marketed to retail investors. With regard to these types of products, it is of great importance to understand how the principle of proportionality should be applied, and to that end, it would undoubtedly be very useful to include, among the examples provided by ESMA, a non-complex CIS.

Finally, although CIS managers as manufacturers of financial instruments are not directly subject to the governance requirements of MiFID II (see question 5), the definition of the target market by manufacturers should be done in an abstract way, although at times ESMA seems to ignore the level of knowledge that they have of customers, demanding them some requirements in the definition of the target market that go beyond what a manufacturer is able to know.

[1] INVERCO is the representative association of Collective Investment Schemes (CIS) and Spanish Pension Funds (PF), as well as of foreign CIS registered in Spain for commercialization ("UCITS"). INVERCO currently represents more than 5,000 Spanish CIS with 258,495 million euros of assets (99% of the total assets in Spain), more than 1,600 PF with 104,518 million euros of assets (99.9% of total assets in Spain) and 24 UCITS with 121,000 million euros of assets.

B. QUESTIONS

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

Firstly, two general aspects of the content of the categories set out by ESMA in its Consultation Document to be applied by the manufacturers should be noted:

(I) The content of the categories should be defined, in the case of manufacturers, depending on the characteristics of the product that will later be offered or marketed by the distributors to their customers or potential customers. Through the characteristics of the product, which is what the manufacturer really knows, is how the customer, in the case of the execution-only service, or the distributor, in the rest of the investment services provided, can assess whether or not the customer has knowledge/experience about the product and if it is appropriate taking into account its financial situation, its risk profile, and its objectives or needs.

(II) The need for the content of each of the categories to be clearly defined and delimited, as far as possible, in accordance with the most standardized criteria possible, otherwise there is a risk that these categories are defined for the same product in different ways by the manufacturers (and by the distributors), and this means that the comparability between the different financial instruments would not be possible, and that the distributors will not be able to receive homogenized information of those instruments, which will seriously hamper the definition of the target market that they have to carry out, if applicable.

Likewise, the aforementioned lack of standardization would severely act against the work of the manufacturers, since they would be subject to the varied and diverse requirements of the distributors, with consequent implications for systems development and increased costs of production of Information, among others. On the contrary, with the same format of information one could even avoid a contract which, where applicable, is necessary between manufacturers and distributors in this respect, since the same standardized information would be valid for all distributors.

For each of the categories referred to in the consultation document, it should be noted that:

1. Type of clients

Categories of the type of clients should be limited to those provided in MiFID, which are retail, professional and eligible counterparty. Therefore, the possibility of using additional categories, such as those set out in the Guidelines or similar, should be avoided, since there is no harmonized definition of them, which would create a high degree of uncertainty in their interpretation, both by the distributors themselves who receive such information from the manufacturers, as well as by the potential investors in the corresponding product.

This would also prevent both the distributor, when receiving the information from the manufacturer, and the NCA, in their supervision work, from assessing the need for a more detailed definition of the type of client related to the type of financial instrument, which could lead to a situation of regulatory arbitrage.

In this matter, ESMA distinguishes between professional client "*per se*" and "*voluntary*" professional client in paragraphs 72 and 73, stating that in the case of the "voluntary" it must be presumed that he does not have a knowledge and experience comparable to the professional client "per se". The truth is that it is impossible for a manufacturer to know when a professional client has decided to "opt up" or "opt down"; therefore the distinction between professional clients "*per se*" and "*voluntary*" cannot have room when identifying the type of client by the manufacturer.

In any case, it would be appropriate for the Guidelines to expressly state that, in the case of non-complex products, it is not necessary to indicate any particular category of client insofar as they are products suitable for the three categories defined in MiFID.

2. Knowledge and Experience

Given that this category is defined in the Guidelines in a very broad and vague way, it is proposed that it should be implemented according to the following sub-categories:

(I) Knowledge and/or experience with financial instruments in general;

(II) Knowledge and/or experience with the financial instruments of this particular nature;

(III) Knowledge and/or experience with highly specialized financial instruments with potential additional payment obligations.

In any case, the contents of paragraph 16 (b), on page 23, is only valid for complex products; and although ESMA recognizes that in certain cases experience would not be necessary, but in any case a "broad knowledge", this would lead to a situation where in practice a large number of potential investors would not be able to invest for the first time in a not complex products, as in the case of unstructured UCITS or non-complex FIA marketed to retail investors, or even in CIS that, although they may be considered as complex financial instruments, nevertheless offer a guarantee to the shareholder or unitholder over 100% of the amount invested. For this type of products, given its particular nature, it should not only be unnecessary for the first-time investor to have experience, but should also not be required to have "broad knowledge"; on the contrary, a basic knowledge that is provided through the UCITS KIID or the PRIIP KIID should be enough. It should be recalled in this respect that the criterion of proportionality in view of the nature of the product must also be taken into account for the purposes of knowledge and experience requirements.

3. Financial situation

Manufacturers are only in a position to define this category to the extent that it is limited exclusively to the concept of ability to bear losses. That is why this category should be redenominated as “Ability to bear losses” instead of “Financial situation”.

In this regard, the following sub-categories are proposed:

(I) The investor cannot assume losses;

(II) The investor can assume losses up to the level specified in the structure of the product;

(III) The investor can assume losses;

(IV) The investor can assume losses beyond the amount invested.

4. Risk tolerance and compatibility with the product risk/reward profile of the product

The Guidelines should expressly indicate that, in addition to what has already been mentioned in relation to the PRIIPS risk indicator, in the case of financial instruments subject to UCITS regulations the risk indicator required by UCITS will be sufficient to take for fulfilled this category, without it being necessary to give any additional information in relation to this category. The same would happen with financial instruments subject to the AIFMD, to which the domestic regulators have extended the requirement of the risk indicator of UCITS. Similarly, for products in which the previous risk indicator is not required, the most relevant risk indicated in the corresponding prospectus should be used.

Notwithstanding the above, it does not seem acceptable that the categories mentioned by ESMA in paragraph 16 (d), "risk oriented or speculative, balanced, conservative", can be used for this purpose, since they are very subjective concepts on which there is not a general understanding and could lead to great uncertainty in its interpretation.

5. Clients' Objectives and Clients' Needs

As previously stated, a manufacturer has not knowledge about the customers, much less their objectives and needs, but can provide information about the product that allows the customer or the distributor to assess whether the product is suitable for its objectives and needs. For this purpose, the manufacturer is in a position to provide the following information about the product: the investment horizon of the product, meaning the recommended holding period. This information should be sufficient to give content to these two categories, especially taking into account what ESMA has proposed in its examples.

Notwithstanding the foregoing and with regard to customer needs, it should be clarified that not all products have specific characteristics or seek to address specific customer needs, such as those indicated by ESMA in the consultation document. So for certain products, particularly for those targeted to mass retail investors, it would not be necessary to complete this category or it would be sufficient to point out that they are not designed to satisfy any particular customer need.

In any case, although in the Guidelines appear as two differentiated categories; since both are highly interrelated and it is difficult to delimit the concept and content of each of them, in particular that relating to the needs of the client, since this is a new concept, it is proposed that both categories should be merged in a single one.

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.

Without prejudice to Q1, the principle of ESMA according to which the target market must be appropriately and proportionally identified, taking into account the nature of the product, is shared. Therefore, for non-complex and simple products, such as UCITS products, which are compatible with the retail mass market, the definition of the target market should be very generic and simple, especially in the case of the manufacturer[2].

In the context of the responsibility of the manufacturer, the section on the articulation between the manufacturer's strategy and its definition of the target market that ESMA deals with in paragraphs 21 and 22 of the consultation document is discussed. It does not seem reasonable that the manufacturer should determine the type of investment service through which a financial instrument should be acquired, much less the determination of the "preferred acquisition channel" (physical presence, via telephone, online, etc...), and in no case the specific design of that acquisition channel, when the Guidelines themselves recognize that the definition that corresponds to the manufacturer must be more abstract and based on the theoretical knowledge of the customers.

The determination of the channel of acquisition by the manufacturer, as currently envisaged in the consultation document, requires a deep and concrete knowledge of the potential customers of the financial instruments, as well as the practical operation of the distribution channels, both of which the manufacturer

[2] It would also happen with those CIS which, although they may be considered as complex financial instruments, nevertheless offer a guarantee to the shareholder or unitholder of 100% of the capital invested and are targeted to retail investors and subject to the same investor information requirements than a UCITS.

does not have knowledge, and that are only available to the distributor. In addition, this would imply the creation of a grey area in terms of determining responsibilities between the manufacturer and the distributor.

Therefore, what the manufacturer can establish as marketing strategies should remain as a mere recommendation that does not oblige the distributor, without prejudice, of course, that the distributor must have adequately justified the measures he takes with respect to his own marketing strategies, for the sake of effective protection of its clients. This is especially true if, as ESMA intends in its Guidelines, the deviation by the distributor of the distribution channel established by the manufacturer takes place in order to increase the protection of the client, or only in a very exceptional situations.

This point is of the utmost practical importance as the current wording proposed by ESMA is not valid for products aimed to the mass retail market, such as UCITS products, which are distributed through all types of channels and thousands of intermediaries. It seems that it is not ESMA's intention, in any case, to restrict the access of such products to all potential investors throughout the territory of the European Union.

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

The approach in paragraphs 23 and 24 of the Guidelines, according to which target market identification must be present from the beginning to the end of a distributor's marketing activity, seems appropriate.

However, the Guidelines should clarify that the target market's identification by the distributor must be made according to the type of service provided. If an entity does not provide advisory or discretionary portfolio management services it will not be in a position (nor is it required) to identify or verify all or part of the information required by ESMA in the six categories, and therefore the target market definition in such detail would entail an administrative burden for the entity and an increase in the risk of litigation.

On the other hand, the Level I of MiFID II does not establish any hierarchy between the target market defined by the manufacturer and the distributor. Therefore, the target market defined by the manufacturer, should be taken into account by the distributor when defining his own, and in practice the majority will be respected by the distributor and both will coincide, but not necessarily limit the distributor's ability to make their own decisions regarding their customers. Therefore, it is proposed to be removed from the Guidelines the reference to that deviation from the target market described by the manufacturer should be a limited occurrence, as well as the fact that it is considered a "good practice" for the distributor to generally respect the target market as identified by the manufacturer (paragraph 35), notwithstanding that the distributor has to justify, where appropriate, the reason why it departs from the target market defined by the manufacturer. A clear example of how in practice a distributor may deviate from the target market defined by the manufacturer, without distributor's responsibility, is the assumption that an intermediary or advisory client who is informed that the product is not suitable for him because it does not enter within the target market defined by the manufacturer, and yet the client decides that he wants to continue with the acquisition of the product, so that the financial entity must proceed to execute the client order.

Finally, and in line what is set out above for manufacturers, the definition of the target market for non-complex products, and in particular those of more common use, should not require the distributor to analyze in depth their customer base, as required by ESMA in general for distributors (paragraph 33). In this regard, it should be recalled that ESMA itself recognizes that in the case of simple products, they can be distributed through execution only, so that in principle any potential investor can have access to such products.

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 agree with ESMA recognizing that aspects related to hedging instruments, diversification of the portfolio and the specific characteristics of a client can justify deviations from the defined target market.

However, ESMA's proposal that sales outside the target market can only take place in a restricted/limited and exceptional way in these cases is not shared. Taking into account that the definition of the target market focuses on the individual product and its characteristics, and that, however, the distributor can provide advice on an asset portfolio or discretionary portfolio management services, it is almost likely that there will be a discrepancy between the two regimes or processes. Without doubt, if a product is distributed or advised in conjunction with other financial instruments or is to be included in a portfolio with other financial products, the client and/or his adviser must take into account its combined effects.

Likewise, the categories indicated by ESMA and its variables may not be meaningful and therefore may not be applicable or may differ in the case of products that have a hedging purpose, so that entities must be given flexibility to adapt them to such cases. For example, the criterion of ability to bear losses would not make sense when determining the target market of a hedging instrument.

Moreover, the assertion that deviations from the defined target market cannot occur on a regular basis opens the door to a different approaches to supervision by the different regulators in Europe. The proper approach should rather be an adequate documentation of why this deviation has taken place.

The EU and the relevant national regulation itself already has specific investor protection rules relating the investment of assets in the case of portfolio management service or advice on a set of financial instruments, in particular through the suitability questionnaire.

The target market limits to whom the product is offered. But it does not make sense to limit the decision-making power of a portfolio manager, who already has its own framework in which must operate the investment decisions for its clients.

On the other hand, ESMA should take into account that discretionary portfolio management is not a form of distribution, since the decision to invest in a financial instrument does not correspond to the final investor, but to the manager. In this case, what the investor is purchasing is not a financial instrument, but a service, the discretionary management of his portfolio by a professional third party, and the acquisition or not of financial products is a mere consequence, but it is not the principal purpose of this service.

Therefore, the Guidelines should expressly exclude from its application the portfolio management activity and even those cases where financial advice is provided not in isolation for each financial instrument, but on a global basis taking into account all the assets that make up the client's portfolio. That is to say, in these cases, the manager or the advisor does not have to take into account the target market defined by the manufacturer, since the manufacturer has defined it for the individual product in isolation, whereas the manager and the advisor must assess the target market in light of/based on the portfolio in its entirety or the set of instruments advised, respectively.

Finally, it should be noted that ESMA's proposal could severely restrict diversification of a portfolio and diversification is key and an integral part of a client's portfolio that must certainly be firmly defended and supported. In particular, when a product is purchased as part of a well-diversified portfolio, deviations from the target market could be very convenient for a customer and therefore permissible. Although ESMA adequately mentions the importance of diversification in the Consultation Document, it does not do so in the Guidelines themselves. With this in mind, it is clear that ESMA has to reconsider its current positioning on the possibility of the distributor to make sales outside the target market defined by the manufacturer, and put it in the proper context in the Guidelines in relation to the diversification of the portfolio.

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?

UCITS and AIF managers do not fall within the scope of the product governance requirements provided for in MiFID II[3]. In this regard, the Guidelines should expressly state that distributors should not enter into contracts, unless voluntarily agreed upon by both parties, with UCITS or AIF manufacturers who impose on them the compliance with the product governance requirements set out in MiFID II. As stated in MiFID II, the contract should be limited to establishing what information should be provided by the manufacturer to the distributor and the definition of responsibilities between those two.

Notwithstanding the above, it is necessary to clarify in the Guidelines the following aspects in relation to the information that a distributor must obtain in:

(i) The situation where there is insufficient public documentation: the type of efforts and checks that an entity must make under these circumstances should be further specified.

(ii) The situation where there is a public documentation subject to a specific regulation, as is the case of UCITS and PRIIPS: it should be specified more clearly which products require no further verification by the distributor than using the relevant public document.

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

It does not seem to make much sense to define a negative target market when a positive target has been defined too; in particular, bearing in mind that ESMA suggests that sales outside the positive market should take place only on a limited occurrence (although we have already indicated above that this should be deleted from the Guidelines).

Conceptually, there should not be situations that fall neither in the positive definition of target market nor in the negative definition. That is, the negative target market would be defined by the mere opposition to the definition of the positive target market.

Therefore, to include a negative definition does not bring anything new, and yet creates unnecessary doubts about whether the positive definition is not really such, since it would be the negative that defines the target market, creating levels of legal uncertainty to the distributor, and potentially limiting the access of certain products to customers who might otherwise acquire them.

In addition, for products targeted to mass retail market on a widespread basis, such as unstructured UCITS or non-complex FIAs for retail investors, they cannot have a negative target market, as indicated in question 8 with the example that INVERCO proposes.

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

In general, ESMA's approach on this point is appropriate.

However, the comment in Q1 in relation to the distinction between professional clients "*per se*" and "*voluntary*" should be taken into account in this regard.

[3] This is expressly provided for in both Level I and Level II of MiFID II when defining its scope. Fund managers are only subject to governance requirements when providing investment services but not in their collective management activity.

Finally, it should be noted that the discretionary management service is often provided in the form of discretionary mandates to professional clients and eligible counterparties. If the manager is required to evaluate the target market for each investment decision as if it were a distributor, the mandate and the discretionary management service as such would not make sense.

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

While the fact that ESMA has included examples in the consultation document is appreciated, even though all of them are related to complex products, as already indicated at the beginning of this response document, it is necessary to include an example of a non-complex product of generalized distribution, as it could be the case of a non-complex UCITS. To this end, it is suggested that ESMA include in the Guidelines an example similar to the one below, and on which the Guidelines have been applied, taking into account the principle of proportionality, given the nature and characteristics of the product.

EXAMPLE: NOT-COMPLEX UCITS

Product: European Equity Fund

Target Market

- Type of customer: all types of customers
- Knowledge and experience: basic knowledge of how the product works
- Financial situation: ability to bear losses
- Risk tolerance: Risk indicator (5) of UCITS KIID
- Customer objectives:
    - Time horizon of investment: long-term[4] investment (will coincide with the recommended holding period set out in the KIID)
- Customer needs: no specific characteristics
- Negative target market: there is no negative target market
- Preferred channel of distribution[5]: all kind of distribution channels

On the other hand, ESMA in paragraph 56 indicates that products designed prior to January 3, 2018 but distributed after that date are subject to the MiFID II governance requirements and thus to the Guidelines. However, it is necessary to establish a reasonable transitional period for both manufacturers and distributors to comply with those obligations.

Finally, in the interests of regulatory convergence and in order to ensure harmonization of the different EU regulations on investor protection, the concept of target market in PRIIPS and MiFID II should be homogeneous. It would not make sense for manufacturers of products subject to PRIIPS to have a target market definition in accordance with MiFID II, and then have to redefine it in accordance with PRIIPS regulations in this area. This would lead to an unnecessary and unjustified administrative and operational

[4] Exceeding 3 years.

[5] As we have indicated in the answer to Q2, it is not up to the manufacturer to determine the type of investment service through which a financial instrument should be acquired, much less the determination of the preferred channel of acquisition of a product. However, in the event that ESMA eventually consider its definition by the manufacturer to be necessary, "all kind of distribution channels" would be the information that would be provided by the manufacturer for this type of financial instruments.

burden on the entities, without in any case implying an additional benefit, rather the opposite, for the potential investor.

Q9: What level of resources (financial and other) would be required to implement and comply with the Guidelines (market researches, organizational, 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 organization and the nature, scale and complexity of the activities of your institution, where relevant.

No specific figures are available on the level of resources needed to implement and comply with the Guidelines. However, the timing of the publication of these Guidelines is of concern.

Taking into account the important implications that they will have in the operation for both manufacturers and distributors due to the changes and novelties that they will introduce, the Guidelines should be published as soon as possible, since even the date scheduled for publication, the first quarter of 2017, is too short a deadline for its due and complete implementation.

Madrid, 4 January 2017