European Securities and Markets Authority (ESMA)
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Response of the Italian Certificates and Investment Products Association (ACEPI) to ESMA's Consultation Paper on Draft guidelines regarding on MiFID II product governance requirements as of 5 October 2016 (ESMA document reference 2016/1436)

Dear Sir or Madam,

ACEPI appreciate the invitation by ESMA to contribute to the captioned consultation and provides herewith its answer to ESMA's Consultation Paper.

ACEPI is the association representing the Italian certificates and investment products industry and a member of EUSIPA. It is a non-profit association that supports uniform market standards, transparency and understandability of investment products.

ACEPI hope the attached provides sufficient background on our position and are available for any further clarification in relations to the comments made.

Best regards,

Dario Savoia
Chairman
ACEPI

ACEPI response to the Consultation Paper on Draft Guidelines on MiFID II Product Governance requirements – ESMA/2016/1436

General comments

ACEPI consider necessary and appropriate a non "narrative" approach in the definition of target market criteria and do not support the proposed narrative description used in the illustrative examples and case studies, also because the proposed approach leaves the door open to different interpretations that could therefore hinder the objective of ensuring a common and consistent implementation of the 'target market assessment'.

The target market criteria should be **objective** and **based on closed lists of items to rate each criteria**.

The proposed "narrative" approach is also not compatible with PRIIPs' KID, because the KID content must be limited to 3 pages.

Implementing different methodologies may lead to inconsistencies between the MiFID II target market and the PRIIPs target market.

ACEPI believe that the principle of a proportionate approach is essential for the application of MiFID II product governance requirements. Consequently ACEPI agree with ESMA's proposal that the identification of the target market assessment should be done in an **appropriate and proportionate manner** for both manufacturer and distributor, considering the nature of the investment product, the investment service provided and taking into account the product complexity and the product-client relationship: assessment of the target market shall be lighter if a client is an eligible counterparty, compared to the assessment of the target market to be made vis-à-vis a retail client.

Additional guidance would ensure a common and consistent approach in the implementation by investment firms.

ACEPI share the view of ESMA that the target market assessment **must remain product-related for the manufacturer**, rather than referring to personal features of clients, considered at the individual point of sale.

ACEPI also welcome the Draft Guidelines' **attention to the salience of portfolio diversification**, also in terms of investors' protection. ACEPI are of the view that portfolio diversification is key to any sound medium or long term investment strategy as regards portfolio management and investment advice services.

Finally, the assessment of the target market has to duly consider the services actually provided by Distributors. In particular, where firms only carry out execution services with the assessment of

appropriateness, this assessment will be limited to the sole categories of knowledge and experience of clients.

However the current ESMA Draft Guidelines could lead to a fundamental change in the way products may be distributed, as could notably restrict the ability to market products in an execution-only or an appropriateness mode.

Responses to specific questions

Questions reference

Q1 **Do you agree on 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.**

ACEPI agree with the list of categories presented by ESMA.
Nevertheless, ACEPI are of the view that the description of some categories should be clarified.
Target Market categories should be assessed with explicit criteria.
Indeed, at manufacturer level it is not possible to assess products with detailed qualitative criteria and manufacturers should keep using descriptive parameters.
To allow manufacturers to define the target market in due time, given the significant diversity of financial instruments and relevant issuance volumes, automation will be key. Automation is only possible when standardized and simple narratives are used.

C1. The type of clients to whom the product is targeted:

At manufacturer level this category has to be assessed in a wider manner (i.e. generic and not client-specific).
Qualitative criteria should not be used to identify potential target market.
Subjective criteria like "*private wealth clients*", or "*sophisticated clients*" would be subject to interpretations and will imply heterogeneous client categorisation at distributors' level.
ACEPI consider that the additional objective split within the MiFID II Retail category e.g. *Individuals* and *Non individuals* (Corporate that do not meet the professional criteria) is more relevant.
A proposed 'closed list of items' could be:

"*This product has been designed for [C1]*

C1
eligible counterparties, professional clients, or retail clients
eligible counterparties, or professional clients
eligible counterparties

who ... "

C2. Knowledge and experience:

ACEPI agree with the possibility **to compensate limited or no experience with knowledge, especially when there is an extensive financial knowledge**.

It is paramount to ensure that clients with limited *ad hoc* experience (eg. young investors setting up long term saving plans for the first time) still have the opportunity to invest in financial instruments.
It should also be made possible to clients that have experience of certain products to invest into "new" products, which they have not purchased before.
Therefore, ACEPI suggest amending paragraph 16(b) of the Draft Guidelines so that knowledge and experience can be considered as alternative criteria, depending on clients' circumstances (i.e., no knowledge needed, knowledge of the financial markets or knowledge of the asset class, knowledge of the financial markets and of the financial product).

Concerning the specific case of investment advice, situations where the client neither has knowledge nor experience for the contemplated investment can be blocking.
In this context, ACEPI consider that the lack of knowledge can be compensated through the explanations about the financial instruments given to clients, so that they can get a proper understanding of the product and then a relevant appropriateness test would be positive.

Concerning the criteria, ACEPI suggest that the assessment of knowledge and experience should be performed per asset class / underlying (Equity, FX, Rates, Commodities ...) and product type / feature (UCITS, Alternative funds, structured products / funds, derivatives). These criteria should be assessed with a 'Yes' or 'No' rating.
Target market definition should highlight if the understanding of a specific asset class or wrapper is needed or not.

A proposed 'closed list of items' could be :

"*... have sufficient knowledge of financial markets, and specifically* [C2-a] *and* [C2-b]"

C2	**KNOWLEDGE AND EXPERIENCE**
C2-a **Asset class / Underlying** *(several choices possible)*	**C2-b** **Product type / feature**
None	None
Equities	UCITS
Forex	Alternative funds
Rates / Govies	Structured products / funds
Credit / Bonds	Derivatives
Commodities	Capital risk, Private Equity

C3. Financial situation with a focus on ability to bear losses:

ACEPI consider that **the approach must remain product-centric** for manufacturer and not be based on clients' personal features.
ACEPI suggest that criteria should be based on the assessment of the capital protection and potential loss levels of the product.
In particular, ACEPI propose the following levels:

- Full capital protection (at maturity), no potential capital loss;
- Partial capital protection (at maturity), potential partial capital loss;
- No capital protection, potential full capital loss;
- No capital protection and potential additional payments required, potential loss of more than the capital invested.

In the description of category (c) *Financial situation with a focus on the ability to bear losses,* firms are required to specify the amount of losses that target clients should be "*able and willing to afford*".
The "*ability to bear losses*" is, however, one of the factors which: (a) the investment service provider, having a direct relationship with the investor, must obtain information about, and (b) must be taken into account in the assessment of suitability

(MiFID II, Art. 25, par. 2). Therefore the manufacturer, if different from the distributor, when defining the potential target market should just specify "how much" target clients are willing to risk to lose.

In light of the above, ACEPI propose to amend the wording of the Draft Guidelines by deleting "*able and*", at least in relation to the potential target market defined by the manufacturer. The relevant sentence should therefore be amended as follows: "*The firm should specify the amount of losses target clients should be willing to afford*".

C4. Risk tolerance and compatibility of the risk/reward profile of the product with the target market:

ACEPI support ESMA's proposal on the possibility to use PRIIPs risk indicator, where applicable.

For **non-PRIIPs products, ACEPI suggest a clear specification of the product risk by using criteria such as 'low risk', 'medium risk', and high risk'.**

Concerning **hedging products**, ACEPI consider that the risk tolerance category should be deemed not relevant at product level as it does not make sense to assess the product on a standalone basis irrespective of the risk/instrument hedged.

A proposed 'closed list of items' could be:

"On a risk category from 1 (very low risk oriented and very low to low return) to 7 (very risk oriented / highest return) this product falls in risk category [C4a]"

Or for non PRIIPs

"This product falls into risk category [C4b]"

C4	RISK TOLERANCE
C4-a **applicable to Priips only**	**C4-b** **applicable for all other products**
1	low.
2	medium.
3	high.
4	
5	
6	
7	

As regards category (d) *Risk tolerance and compatibility of the risk/reward profile of*

the product with the target market, the Draft Guidelines suggest the use of categories that describe the general attitude towards risk of the target client and whose taxonomy is conventionally defined by the entity that identifies the target market.

Considering that the different players in the distribution chain may adopt completely different models in defining the relevant categories ("*Since different firms in the chain may have different approaches to defining risk*..."), it is reasonable to expect that the classifications adopted by different market participants do not have common criteria. In such scenario the distributor may not be able to ensure that the distribution is consistent with the potential target market defined by the manufacturer. This situation is even more likely when many entities are involved in the distribution chain.

In the event that the classification used by the manufacturer must be adopted by entities which are downstream in the distribution chain, such entities would incur in compliance costs that may not be compatible with, or be excessive in relation to, the nature/size of the business.

Conversely if the classification used by entities which are downstream in the distribution chain must be adopted by the manufacturer, the latter will have to bear costs which may not be compatible with, or be excessive in relation to, the nature/size of the business, also because the manufacturer will have to consider the models – typically different – of all the relevant distributors involved (including distributors which are intermediate in the chain of distribution).

As regards the reference to the *risk indicator* (SRI) set out by the PRIIPs Regulation, given that, where required, a KID containing the SRI will be provided to investors, **a reference to the SRI also in the target market seems unnecessary and redundant.**

A key factor of the "risk tolerance" is the size of the bearable losses; a factor that is already considered under category (c) (such circumstance can be clearly observed also in the case studies attached to the Consultation Paper).

In light of the above, ACEPI propose that category (d) becomes discretionary in the potential target market defined by the manufacturer, and to amend accordingly par. 14 of the Draft Guidelines.

C5. Clients' objectives:

ACEPI are of the view that the expected investment horizon (holding period), remains the most important criteria when specifying the investment objectives of target clients.

ACEPI suggest the use of product time horizon criteria like '*short term*', '*medium term*', '*long term*', and exact underlying time ranges (e.g. months) to be fine-tuned

and harmonized.

A proposed 'closed list of items' could be :

"this product targets investor with an investment horizon of [C5]

C5
short term
medium term
long term

C6. Clients' needs:

ACEPI's suggested approach is to specify:

First, the objective or rationale for the client in entering into the transaction like: *'making an investment', 'hedging', 'financing', 'yield enhancement', 'management of balance sheet, accounting, regulatory ratios'.*

Second, if the rationale is an investment:

- the product return type, income or capital growth.
- the diversification approach e.g. *'Core investment in the portfolio / 'Diversification Component of the portfolio'*.

As stated in our general comments, ACEPI wish to introduce a diversification criterion in the clients' investment needs. In line with the spirit of ESMA's position on portfolio diversification, ACEPI consider that both manufacturer and distributor should be able to take into account diversification purposes in the identification of target market. *(idem Q4 below)*

A proposed 'closed list of items' could be :

"The objective of the transaction is [C6]*"*

C6 – CLIENT NEEDS
Preservation of capital
Growth
Income
Hedging

In addition, as regards category (f) *Clients' Needs,* ACEPI believe that the definition proposed in the Draft Guidelines is too general and can, therefore, be ineffective.

On the other hand, ACEPI agree, as specified with reference to *Clients' Objectives* ("*objectives can be fine-tuned by specific clients' needs*"), on the nature of the clients' needs as an additional qualifier of the investment objectives and therefore, not always necessary.

Also par. 34 of the background of the Consultation Paper appears to be based on this view, where it refers to objectives and needs in an alternative way *("...meet client's objectives or needs.", "...could satisfy the speculative objectives/needs of some clients...", "...end-clients, each of them characterised by different objectives or needs,...*").

In light of the above, ACEPI propose that category (f) *Clients' Needs,* becomes discretionary and to amend accordingly par. 14 of the Draft Guidelines.

In light of its importance for manufactures, ACEPI request to transpose in the text of the Draft Guidelines the content of par. 12 of the Consultation Paper.

ACEPI consider necessary that par. 13 of the Draft Guidelines, where the manufacturer is required to provide qualitative considerations in the target market identification, should be further clarified, in view of a better convergence of market practices.
In this respect it would be also useful to integrate Annex 4 (*Illustrative examples and case studies related to the application of certain aspects of the guidelines*) with specific cases of potential target market identified by manufacturer that do not perform any activity as distributor.

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.**

ACEPI's view is that that all products, whether complex or not (e.g., AIFs, OTC derivatives , structured investment products, UCITS , non-senior debt instrument such as subordinated debt), must go through a target market assessment **in accordance with the 6 criteria defined by ESMA, using a comparable metrics**.

This would:

a. allow investors and distributor (if any) to compare the expression of the target market,

b. ensure that all investment products are on an equal playing field, and

c. when there is a distributor involved, ensure that all manufacturers use a similar metrics (and as such would assist distributors in comparing the manufacturer TM with their own TM assessment).

ACEPI do favor a simplified assessment of the criteria for all non-complex financial instruments, as listed in article 25(4)(a) of MiFID II Directive (shares, bonds, non-structured UCITS).

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

ACEPI is of the view that distributors will be able to make operational and consistent target market assessment for comparable products if the target market has been defined by their manufacturers in an objective manner (i.e. using the 6 explicit criteria).

ACEPI disagree with footnote 16 of the Draft Guidelines which seems to contradict paragraph 39 of the Draft Guidelines. In fact, ACEPI think that under execution only regime, by nature, no thorough assessment of the target market should be required and the assessment has to be limited to the categories of knowledge and/or experience only, as stated in paragraph 39.

ACEPI also disagree with Draft Guidelines paragraph 27 idea that "*distributors should conduct a thorough analysis of the characteristics of its client base, [...] and should use any information and data deemed reasonably useful and available for this purpose*" . This approach is in contrast with the principle of proportionality (mentioned in paragraph 35) and the over-all approach regarding common products and/or

execution only service, where only a limited amount of information on clients is required and therefore available for manufacturers.

If all the six criteria should be used in all the three distributions types (i.e. execution-only, appropriateness, suitability), ACEPI recommend for each situation to operate a distinction between matching and disclosure criteria as follows:

1. Execution-only:

All criteria are disclosure-only.

2. Appropriateness:

a) Matching criteria:

- type of clients
- level of knowledge and/or experience

b) Disclosure criteria:

- risk appetite
- ability to bear losses
- objectives
- needs

3. Suitability:

All criteria are matching criteria.

For products that are only eligible to an appropriateness-based or a suitability-based distribution (e.g. structured products, derivatives), these products will also be subject to PRIIPs and give rise to the issuing and distribution of a KID.

For simple products such as stocks or bonds that are eligible to execution-only, ACEPI consider that generic target market descriptions common to the entire product class should be an acceptable solution if ESMA intends to apply the six criteria to them.

Regarding the requirement to report deviation, ACEPI note that information reported depended should depend on the investment service and/or the product provided. For example, when distributors provide execution only services, they could not know whether investors fall within the target market or not. Likewise, when those distributors provide services subject to appropriateness, their ex-post verifications of

the effective reaching of the target market will only be based on the knowledge and/or experience criteria.

Also, in light of the proportionality principle, ACEPI consider that the requirement to report deviation from the target market should not apply to legitimate diversification situations duly assessed by 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.**

ACEPI wish to stress that diversification is the corner stone of a sound assets allocation and of the advisory and portfolio management investment services provided to a large proportion of ACEPI's members' clients.

For this reason, **diversification should not be seen as an exception that should remain rare and distributors should not be required to report to the manufacturer deviations from the target market that are the direct result of diversification needs**.

In addition, to avoid any misunderstanding, diversification should remain subject to positive suitability test (i.e., the financial instrument will not trigger not compliance with the client risk profile).

Concerning hedging products, see in Q1 ACEPI's suggestions regarding how the criteria could be rated for hedging products.

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?**

ACEPI do not believe further guidance should be developed since relevant issues are already addressed in the Directive and the Delegated Directive pertaining to the adequate arrangements and necessary due diligence that distributors would need to have in place for products manufactured by entities falling outside the scope of MiFID II.

ACEPI also highlights that the "manufacturer" may not always be the "issuer" (see

paragraph 51 et seq. of the Draft Guidelines). It might be the case that products which are issued by a special purpose vehicles, or other entities which are not subject to MiFID II, embed the structuring provided by other entities within a group (which is a quiet frequent situation within a group). Therefore, it should be explicitly stated in the Draft Guidelines that the distributor's obligation to define the target market is applicable only in case of structured products for which no entity assumes the role of "manufacturer".

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

In the Delegated Acts released on April 7th 2016 in Article 9 (9), it is stated that "*the firm shall identify any group(s) of clients for whose needs, characteristics and objectives the financial instrument is not compatible*".

ACEPI are of the view that (i) the **positive target market is sufficient** to define the scope of target end investors, and (ii) the negative target market seldom proves to be useful information, and in any case it should not be described with the same granularity as the positive one. ACEPI consider that, where an *ad-hoc* exclusion seems necessary, it would make sense the use of a short disclaimer, describing in simple terms the objectives and needs with which the product is not compatible. This solution would be more efficient than the systematic definition of a negative target market.
Nevertheless ACEPI support the ESMA's proposal that the negative target market can be defined by stating that the product or service is incompatible for any client outside the positive target market *(§59, p.32 of ESMA CP)*. Overloading clients with (arguably useful) information lessens the wish to make choices and impairs the choices they make.

Moreover, for certain categories of products or offers, the negative target market could systematically and simply consists of all investors that are not included in the positive target market. **ACEPI request, for such cases, to provide for a simplified procedure in relation to the negative target market description.**

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

ACEPI support ESMA's proposal for a less comprehensive assessment where end-clients are eligible counterparties. Where the product is distributed to an eligible counterparty, it would be useless to define and assess some of the other criteria which will be deemed met in all circumstances. Furthermore, in this situation, **ACEPI agree with ESMA draft guideline #20 which provides that for bespoke products**, all the criteria would be deemed to be matched, since **the target market will be the client who ordered the product. However, ACEPI suggest to extend this approach to professional clients as well when they trade a product for their own account (i.e. not distribution).**

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

Distribution strategy:

ACEPI consider that the specification of the preferred acquisition channel should not be proposed by manufacturers since they do not possess sufficient information necessary for this assessment. ACEPI believe the preferred acquisition channel shall only be defined by the distributor, based on factors such as its specific client base, distribution tools, Relationship Managers training etc.. ACEPI are of the opinion that in principle, there is no advantage if the manufacturer proposes a specific acquisition channel to be used by the distributor. Distributors know their clients well and the proper tools and channels to be used for addressing their clients. In addition, ACEPI would like to note that acquisition channels need to fit for products of different manufacturers.

Open question:

Do we agree with ESMA's proposal that '[...]*when the manufacturer can choose the distributors of its products, the manufacturer makes its best efforts to select distributors whose type of clients and services offered are compatible with the target market of the product.'(§21, p. 24 ESMA CP)?*

ACEPI agree that manufacturers have to put in place proper due diligence on their distributors. ACEPI, however, disagree with the proposal according to which manufacturers should '*select distributors whose type of clients and services offered are compatible with the target market of the product'.* The performance of this additional task is unrealistic and unfeasible as manufacturers are not in a position to receive and assess, in a comprehensive and objective manner, this kind of information.

Regular review of target market and information between distributors and

manufacturers:

ACEPI propose a standardized reporting, to exchange information at maximum on an annually basis.
ACEPI consider that bilateral agreements (e.g. SLAs, distribution agreements) can be used to frame the regular review of target market and should reduce the overall costs of the target market monitoring.
Concerning the specific situation where products manufactured within EEA are distributed outside EEA, it should be noted that conducting such arrangements would be strongly challenging.

Information gathered through all investment or ancillary services:

To assess the target market, distributors should only be required to collect client information relating to the 6 criteria of the assessment. This does not prevent them from collecting further client information for other purposes, such as the suitability test.

Indeed, ACEPI consider that distributors should **not** be required to define their product assortment by using "all" client information and data at their disposal (including information collected within the frame of other transaction, other investment channels, etc.), to conduct a more thorough assessment of the target market. This approach, if confirmed, would result in preventing the distribution of products on an "execution only" basis.

Distributor

In relation to the definition of "*Distributor*" (fourth item of par. 6 of the Draft Guidelines), in order to better clarify its scope, **ACEPI suggest to specify that it refers to the firm that have direct contact with end-investors**, in line with what already expressed in ESMA Opinion "Structured Retail Products - Good practices for product governance arrangements" (ref. ESMA/2014/332, 27 March 2014): "*In practice, **within the supply chain for an SRP, the distributor is the last link**: i.e. it is the firm has the direct contact with investors, to whom it sells the SRPs issued either by itself (acting as a manufacturer and distributor) or by other firms (manufacturers).*"

As a consequence, **ACEPI ask to clarify that the transactions proposed or concluded on anonymous secondary markets - through trading venues - by the manufacturer, or by other operators, should not be considered carried out in a distributor role.**

Same considerations apply to trading on own account carried out by the manufacturer over the counter, with other intermediaries acting on behalf of their end-investor clients.

Application of product governance requirements to the distribution of financial instruments that were manufactured or issued before the entry into application of MiFID II

With regard to the *Application of product governance requirements to the distribution of financial instruments that were manufactured or issued before the entry into application of MiFID II* (par. 40 of the background and par. 55, 56 and 57 of the Draft Guidelines), ACEPI ask to specify that the "distribution" refers only to the offering/selling phase during which the intermediary having contacts with the end-investor – intermediary that only at this stage can be considered as a "distributor" – is in some way bound by agreements with the manufacturer and is, therefore, an integral part of the distribution chain organized by the manufacturer.

In this perspective, ACEPI also ask to clarify that the manufacturer is not required to define the relevant potential target market of products sold/distributed in a primary market period ending before 2018 and not due before 3 January 2018, since they are financial instruments which are no longer subject to "distribution" (unless, of course, any additional "distribution" phase is activated). Consequently, no such requirement would apply in the "review phase" of such products.

MiFD II and PRIIPs KID

In general, since Directive 2014/65/EU (MiFID II) and Regulation (EU) No. 1286/2014 (PRIIP KID) will be effective simultaneously, it is appropriate that the Draft Guidelines give **specific instructions on how to connect the identification, by the manufacturer, of the potential target market under the MiFID II with the features of the retail investor to which the product is intended to be sold**

(intended retail investor) that PRIIPs legislation require to specify in the Key Information Document (please see in particular Regulation (EU) No. 1286/2014, art. 8, paragraph 3, letter 'c', sub 'iii' and related Draft Commission Delegated Regulation (EU) of 30.6.2016, art. 2, paragraph 3).

Q9 **What level of resources (financial and other) would be required to implement and comply with the Guidelines (market researches, organisational, IT costs, training costs, staff costs, etc., differentiated between one off and ongoing costs)? If possible please specify the respective costs/resources separately for the assessment of suitability and related policies and procedures, the implementation of a diversity policy and the guidelines regarding induction and training. When answering this question, please also provide information about the size, internal organisation and the nature, scale and complexity of the activities of your institution, where relevant.**

There are significant costs to be considered:

One-off costs (IT + implementation costs) that may be broken down as such:

- Initial IT investments
- procedural enhancements (business, compliance and legal)
- consultancy fees
- trainings costs
- Legal costs, including the repapering with distributors

Running costs:

- Running IT costs (technology and use of product data)
- control and compliance costs
- information exchange