MiFID II Product Governance

AIC response to ESMA's consultation on product governance guidelines

The Association of Investment Companies (AIC) is the trade association for the closed-ended investment company sector, representing 342 investment companies with £144bn of assets under management. Investment companies are closed-ended collective investment funds whose shares are publicly traded, usually on the main market of the London Stock Exchange. They invest in a broad range of assets including listed equity, unquoted shares of SMEs, property infrastructure and debt (including business to business loans). Investment company shares have been available to investors for almost 150 years and have served them well in that time.

The AIC believes that three principles should underpin the guidelines:

- Product governance is part of a wider framework of consumer protection including suitability and appropriateness. The obligations should not, therefore, duplicate obligations imposed elsewhere by MiFID.
- The concept of a target market should be viewed broadly as any individual product can be held alongside a number of other products.
- The proposals should accommodate both MiFID and non-MiFID products. Where MiFID distributors are distributing non-MiFID products they will still be subject to the product governance requirements, but the obligations should be applied in a proportionate manner.

The guidelines should not, therefore, be too prescriptive about the product or the terms on which distributors can sell products outside the target market proposed by the manufacturer. For products that cannot be sold execution-only, consumers will be protected by an appropriateness test or the need for the distributor to provide advice on which products are suitable.

Responses to questions

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?

The AIC **agrees** with most of the categories to be used as the basis for defining the target market.

The AIC **does not agree** with the inclusion of knowledge and experience as one of the categories that manufacturers should use as a basis for defining the target market for their products.

The level 2 text states that a manufacturer must identify its potential target market and that this should specify the "*type(s) of clients for whose needs, characteristics and objectives the financial instrument is compatible*". It does not, however, specify the knowledge and experience of the client and this factor is already considered by the appropriateness provisions.

The type of client is one of the categories set out in the guidelines by ESMA and so are the needs and objectives of the client. It is not clear, therefore, why the knowledge and experience of the client has been added. The other five criteria – type of client, ability to bear losses, risk tolerance, needs and objectives – will be sufficient to provide a target market to guide distributors.

Including knowledge and experience in the criteria for manufacturers implies testing the knowledge and experience of investors, even if a non-complex product is being sold. The guidance therefore imposes compliance obligations that are not required at Level 1 or Level 2.

The AIC **recommends** that knowledge and experience is deleted from the list of categories included in the guidance.

If knowledge and experience remains one of the categories in the final guidelines, the AIC **recommends** that ESMA makes clear that this should be based on a high-level formulation of knowledge and experience. EFAMA, for example, have considered four categories of client linked to their knowledge and experience.

The examples of target markets provided in the guidelines are overly prescriptive in terms of what could be expected of a consumer and could be unworkable in practice. The example shown in Case study 1 puts forward five elements just in respect of a consumer's knowledge and experience. These include that a consumer should understand "*counterparty risk and the credit rating of the bank that issued the underlying components, including any added risks arising from firms in different jurisdictions working together*". This is far too detailed and risks ruling out products that may be suitable for consumers, particularly where they have an adviser to guide them. It needs to be couched in more general terms such as "familiarity with or knowledge of structured products and their risks and rewards".

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.

The AIC **agrees** with the approach set out in paragraphs 18 – 20 of the draft guidelines.

It is important that it is possible for the target market to be assessed in a proportionate manner based on the product. For straight-forward products that are suitable for a mass retail market, there should be no need for a detailed description of a consumer's knowledge and experience for example.

The AIC **recommends** that the wording from paragraph 17 of the background should be included within paragraph 18 of the guidelines. Paragraph 18 should read (new text underlined):

> *The identification of the target market assessment should be done in an appropriate and proportionate manner, considering the nature of the investment product. This means that the target market identification should consider the characteristics of the products including complexity (including costs and charges structure), risk-reward profile or liquidity, or the innovative character of the product. Consequently, for simpler, more common products, such as ordinary shares, it is likely that the target market will be identified with less detail. In many cases, it is understood that such products can be compatible with the mass retail market. For more complicated products, such as CFDs or structured products with complicated return profiles, the target market should be identified in more detail.*

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

The AIC **agrees** that distributors should follow the same criteria as manufacturers. This should help to ensure consistency in the approaches adopted by manufacturers and distributors.

The AIC **does not agree** that it should be assumed that the product target market developed by the distributor should be more tightly defined or restricted than that developed by a manufacturer. This will depend on the services offered and the clients to whom a distributor provides products and its knowledge of the clients. Some distributors, such as non-advisory platforms, are simply providing a means of access to products. Their business model and the type of service that they provide does not require them to have a detailed knowledge of individual clients. Whilst it is possible that they will employ a more restricted target market, it should not be assumed, or required, that they should do so. Product governance should not apply additional obligations to those envisaged in Level 1. It risks creating higher costs with little, if any, consumer benefit.

The AIC **recommends** that the wording from paragraph 30 of the guidelines should be amended as follows:

> *Distributors should use the same list of categories used by manufacturers (see paragraph 16), as a basis for defining the target market for their products. ~~However, d~~Distributors should define the target market ~~on a more concrete level and should take~~ taking into account the type of clients they provide investment services to, the nature of the financial instrument and the type of investment services they provide.*

The AIC **does not agree** that a distributor should necessarily carry out a "*thorough analysis of the characteristics of their client base*" (as set out in paragraph 33). The need to understand the client base will depend on the nature of the service provided by a distributor or the products that it is distributing. As paragraph 39 points out, it may be the case that the distributor's knowledge of its client base is very limited. This is not a problem if the service provided by the distributor is just a means to transact. In these circumstances the distributor should be able to make use of its knowledge of the product class and information (including the distribution strategy) provided by the manufacturer. For mainstream, non-complex products, the target market will be very broad and it can be assumed by the distributor that they are likely to be well understood by their client base.

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.

The AIC **recommends** that the guidelines should be made clearer in their approach to the sale of products outside the manufacturer's specifically identified target market.

The guidelines are currently too focused on individual products and consider them in isolation from the rest of a consumer's portfolio. In reality, consumers are unlikely to be purchasing any product in isolation and may have different reasons for purchasing products. For example many consumers will be looking to spread risk through diversification – i.e. purchasing a range of different products with potentially different levels of risk. This is explained in the background note on the draft guidelines. It is less clearly set out in the guidelines themselves which suggest that sales outside the target market should be a "*rare occurrence*". The guidelines should be less prescriptive on this point as there is a range of reasons why sales might be outside the target market, without necessarily being contrary to the interests of the consumer. In addition, product governance requirements can never eliminate all poor product decisions, but can aim to minimise them.

The AIC **recommends** the following changes to the guidelines to reflect this:

- Paragraph 29 of the guidelines should be amended to reflect some of the explanatory text from paragraph 30 of the introduction. It should read:

  The obligation of the distributor to identify the actual target market and to ensure that a product is distributed in accordance with the actual target market is not substituted by an assessment of suitability or appropriateness and has to be conducted in addition to, and before such an assessment. In particular, the identification, for a given product, of its target market and related distribution strategy should help ensure that the product ends up with the type of customer for whose needs and objectives it had been designed, instead of another group of clients with which the product may not be compatible. This should not, however, prevent the distribution of the product to customers outside the group, whose individual requirements may make the product suitable or appropriate.

- Paragraph 62 of the guidelines should be amended as follows:

  As the negative target market is an explicit indication of those clients for whose needs, characteristics and objectives the product ~~is~~ may not be compatible, ~~and to whom the product should not be distributed,~~ ~~the~~ any sale to investors within this group should be ~~a rare occurrence, the justification for the deviation should be accordingly significant and is generally expected to be more substantiated that a justification for a sale outside the positive target market.~~ based upon the individual requirements of an investor.

- Paragraph 63 also needs to reflect an approach which is based on financial needs rather than on specific products. For example it discusses a "*grey area"* for some products between the positive and negative markets. As discussed above, there may be good reasons why sales outside the positive market are right for particular consumers. This should not be regarded as a 'grey area'.

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?

The AIC **agrees** that, as paragraph 53 of the guidelines proposes, the obligation should be proportionate to the product. Investment company shares, for example, are widely held by retail investors in the UK. They have a well-established and easily understood structure that has been in existence for almost 150 years. Distributors of investment company shares are very familiar with the structure and understand that they are suitable for retail investors who want exposure to a range of underlying assets. Deciding on the appropriate target market for investment company ordinary shares should not, therefore, be a complicated process.

The AIC **recommends** that the guidelines should state that a distributor can place reliance on what a non-MiFID manufacturer sets out in a PRIIPs KID or other material that is prepared subject to European requirements. The KID has to include "*a description of the type of retail investor to whom the PRIIP is intended to be marketed, in particular in terms of the ability to bear investment loss and the investment horizon*". The distributor of an ordinary share of an investment company would still have to determine its own product target market. However it should be able to base this on what is set out in the KID together with all the other regulated material that may be prepared by a non-MiFID product, such as a prospectus.

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

The AIC **agrees** with the proposed approach for identifying the negative target market. As noted in paragraph 60 of the guidelines, the principle of proportionality is important for firms that are developing a target market. For relatively straight-forward products for the mass retail market such as an equity tracker product or an investment company ordinary share, it should be sufficient to say that, if the target market includes most retail investors who will accept an element of capital risk, the negative target market would be those who aim for complete capital preservation.

The AIC **does not agree** that the negative target market should always suggest that the product would be "*incompatible*" for any client outside the positive target market. Nor should it necessarily be seen as a "*rare occurrence*" for firms to make sales outside the target market. The target market is an indication of the consumers to whom a product could generally be sold. However, as individual consumers will have widely varying personal circumstances and risk appetites, a distributor should be able to make its own judgment about whether the product is the right one (particularly if they are providing regulated advice) or respond to clients who want to buy a particular product (particularly if they are providing non-advised transaction services). If the target market is applied as suggested there is a risk that investors will not be able to access products of their choice or that might be most suitable for them as part of a wider portfolio. It could also create inappropriate incentives for manufacturers to 'stretch' target markets to prevent inappropriate limitations on eligible sales.

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

The AIC **agrees** with the treatment of professional clients and eligible counterparties in the wholesale market.

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

The AIC has two additional comments on the draft guidelines.

Distribution

The AIC **does not agree** that a manufacturer should include the preferred acquisition channel in the distribution strategy that it proposes as part of its target market. For most products it should be sufficient for the manufacturer to say whether the product can be sold on an advised or non-advised basis. It should be up to the distributor to determine the best way of meeting the needs of the target market given the nature of the services they provide.

The AIC **recommends** that paragraph 22 of the guidelines should be amended as follows:

> *In defining the distribution strategy, a manufacturer should determine the extent of clients' information necessary to the distributor to properly assess the target market for its product. Hence, the manufacturer should propose the type of investment service through which the target clients should or could acquire the financial instrument.* ~~*If the product is deemed appropriate for a sale without advice, the firm should also specify the preferred acquisition channel (face-to-face, via telephone, online) and the specific design of the acquisition channel, if relevant.*~~

Examples of Target Market

The AIC **recommends** that Annex 4 should include examples of less specialist products that are aimed at the mass retail market. This would enable manufacturers and distributors to better understand ESMA's expectations for the sort of products that are likely to be widely distributed to most consumers. As noted above, the AIC considers that the example target markets set out in Annex 4 are too complex and need to be reconsidered.

The AIC has prepared two examples of possible target markets for investment company shares which are set out below. The AIC regards these as providing the right level of detail as required by Level 1 and Level 2.

Example 1

The product is an investment company ordinary share in the UK Equity Income sector. At least 80% of the portfolio is invested in UK securities with the aim of providing a total return to shareholders from capital and dividend growth. The portfolio is actively managed and investments are selected based on expectations of providing a total return.

Target Market

1. Type of client: eligible counterparties, professional clients and retail clients.

2. Investor knowledge and experience: no prior knowledge required.

3. Investor's financial situation: the retail investor can bear more than a minimal loss from their investment.

4. Risk tolerance and compatibility of the risk/reward profile with the target market: the retail investor is willing to accept a degree of capital risk in order to pursue long-term capital growth and income.

5. Client objectives: long-term capital and income growth.

6. Client needs: the shares are suitable for a significant component of a portfolio. The shares provide ready access to the investor, although most investors should aim to hold this product for five years or more.

7. Clients who should not invest: retail investors who cannot afford more than a small loss of capital invested or who aim to deliver all their future financial needs via a single investment.

8: Distribution channels: as a non-complex product traded on a public market, these shares are suitable for both advised and non-advised distribution.

Example 2

The product is a Venture Capital Trust (VCT) ordinary share. As a VCT, the underlying portfolio is invested in a wide range of eligible SMEs with the intention of providing a regular income for investors. Retail investors can obtain a favourable tax treatment for their VCT investments provided they hold the shares for five years or more.

Target market

1. Type of client: retail clients.

2. Investor knowledge and experience: investors should understand that the shares are designed as one element in a diversified portfolio, and that holding the share for less than five years can have tax implications.

3. Investor's financial situation: the investor can bear more than a minimal loss to their investment and is able to benefit from the tax advantages that accompany VCT shares.

4. Risk tolerance and compatibility of the risk/reward profile with the target market: the investor is willing to accept a higher degree of capital risk in order to obtain tax benefits and potential investment return from investing in smaller, potentially high growth companies.

5. Client objectives: the shares are intended for clients who want capital growth and income, with the risks mitigated by tax reliefs. The shares are likely to be held by investors who already hold a more general portfolio of other investments.

6. Client needs: the potential for longer term capital and income growth with no need for ready access to the investment.

7. Clients who should not invest: retail clients who are unable to have their investment tied up for a minimum of five years, are unable to afford more than a small loss of capital invested or who are unfamiliar with the tax benefits around the VCT structure.

8: Distribution channel: as a non-complex product admitted to trading on a public market, these shares are suitable for both advised and non-advised distribution.

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