

Luxembourg, 5 January 2017

ALFI Response to the ESMA Consultation Paper on Draft Guidelines on MiFID II product governance requirements (ESMA/2016/1436)

Introduction

The Association of the Luxembourg Fund Industry (ALFI) is the representative body of the Luxembourg investment fund community. Created in 1988, the Association today represents over 1400 Luxembourg domiciled investment funds, asset management companies and a wide range of service providers such as custodian banks, fund administrators, transfer agents, distributors, legal firms, consultants, tax experts, auditors and accountants, specialist IT providers and communication companies. The Luxembourg Fund Industry is the largest fund domicile in Europe and a worldwide leader in cross-border distribution of funds. Luxembourg-domiciled investment structures are distributed on a global basis in more than 70 countries with a particular focus on Europe, Asia, Latin America and the Middle East.

We thank ESMA for the opportunity to participate in this consultation on financial sector taxation.

We also support the submission of the European Fund and Asset Management Association (EFAMA).

General remarks

ALFI welcomes the ESMA Consultation Paper, which adopts an overall balanced approach. ALFI would however like to stress that any guidelines on product governance should be proportionate and appropriate in regard of the specificities of the investment fund business. Therefore we take this opportunity to outline the areas where an improvement and adaptation of the text would be useful, in particular with regard to the different but complementary roles and responsibilities of product manufacturer and distributor. Furthermore we would like to underline that most of the Consultation Paper refers to situations where complex products are sold, whereas for UCITS or retail non-complex AIFs which are simple products no real guidance is given.

Finally, we would like to draw specific attention to the assertion in paragraph 36 of the paper which asserts that sales outside of the target market (specifically in relation to SRRI rating) would occur only rarely. This position risks significantly harming client outcomes as it will lead to inappropriate restrictions in investment choice. Effectively restricting many investors, even those with moderate risk appetites, from benefiting from this proven investment approach.

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.

ESMA consultation paper confirms that the guidelines should be applied in a proportionate manner. ALFI believes that beyond the criteria mentioned (nature, scale and complexity of a firm business but also the nature and range of financial services and activities undertaken) the fact that a financial instrument is already subject to a pre-existing set of regulation needs to be taken into account.

Hence, as a general remark we would like to underline that in the case of UCITS, they are by nature diversified in terms of investments, are highly regulated and subject to a number of disclosures that should enable distributors to refine their own target market assessment. This is also the case for AIFs to a certain extent. Moreover the relation between product manufacturer and distributor is of a collaborative nature, and other elements than the pure target market information are exchanged in this context, for example stress tests scenarios under the other product governance rules.

In addition, the fact that UCITS are designated to retail investors and usually sold via multiple intermediaries needs also to be taken into account.

As a consequence thereof ALFI is of the opinion that the financial situation criteria should only be determined by the intermediary who has to refine it and give it more granularity, as it will perform the suitability and appropriateness test. Fund promoters do indeed use intermediaries to distribute their products and cannot assess themselves the individual financial situation of given investors. It is impossible for them to specify a realistic “amount of losses the target market client should be willing and able to afford” without running the risk of giving a false feeling of security to investors who might think that such amount represents the maximum loss possible-whereas the potential loss when investing in a fund is limited to the invested amount.

As regards the criteria of risk tolerance of the investor, once again it must be underlined that fund manufacturers do not know the end investor in most cases. It is up to the distributor to refine his assessment, based on the UCITS KIID and the synthetic risk indicator and not only on the PRIIP KID risk indicator as mentioned in the Consultation Paper (the SRRI being required for UCITS and certain non-UCITS until 2020). If the above elements are not available the risk tolerance should be defined from the key risks identified in the prospectus. Moreover it must be noted that the risk profile of the fund is defined by the management company or the AIFM of the fund and can often be categorised in terms of basic risk-attitudes, as mentioned in the Consultation Paper. Both the risk profile and the risk indicator can be taken into account by the distributor while refining his assessment. In relation to the risk-attitudes mentioned above ALFI would however like to stress that ESMA should avoid using in its guidelines subjective terms such as “speculative”, “balanced” etc, which are open to wide interpretations.

Regarding the client’s objectives and needs, these two criteria should in our view be combined as two elements in a same category rather than be considered separately. Adequate information to assess these parameters are already contained in the fund’s KIID and PRIIPs documents. As a remark, one improvement which would be welcomed is a harmonisation of both documents in terms of definition of holding period and investor profile.

In any case, as mentioned in the annex of the consultation paper, the determination of the target market by the manufacturer should be considered as subject to the principles of proportionality and appropriateness, since in certain situations such manufacturer is not in a position to identify all elements mentioned by ESMA.

As to the knowledge and experience criteria, these should be assessed in the context of the dialogue between the manufacturer and the distributor for the reasons mentioned above (in particular the lack of direct relation with the end investor). The fund manufacturer can only provide the KIID and information relating to the investor profile and should actually stick to these sole elements.

Regarding the criteria of the type of client, in the absence of any European definition of further types of clients ALFI agrees with the criteria as defined by ESMA.

Finally, it is our opinion that the list of categories should be definite and no further categories should be added on a case-by-case basis by individual manufacturers, which could prevent standardisation and make the flow of information between manufacturers and distributors more difficult. Including further elements like age or tax residency as suggested by ESMA could also potentially limit the availability of products on the market and prevent the selection of a suitable product based on broader criteria.

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.

ALFI agrees with the approach proposed in par. 18 to 20 of the draft guidelines. We would however draw ESMA's attention to the fact that the manufacturer should not always be required to specify the choice of distribution method or detail specific acquisition channels, as mentioned in par. 22 of the draft guidelines. Such requirements should not apply to products designed for the retail market, which are distributed through different types of channels and a variety of intermediaries. We support EFAMA's comments on this particular issue.

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

ALFI agrees with ESMA's statement that distributors should use at least the six categories of criteria mentioned in the consultation paper. However it must be noted that the objectives and needs of the investors are already taken into account for the purpose of performing the suitability test provided for in MiFID. The six criteria do actually come on top of those that may be used by the manufacturer in its own target market assessment, since the distributor is the direct link with the investor and is best placed to assess the adequacy of the target market and the investor's individual situation. Of course this assessment should also be subject to a proportionality principle and therefore distributors should be allowed in certain circumstances to rely on the manufacturer's target market assessment, for example in case of products that are compatible with a mass retail target market.

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.

Moreover, we are not in agreement with ESMA's view that sales outside a target market can be only a limited occurrence, especially in relation to SRRI. As recognised in the Consultation Paper, diversification is important. Unfortunately this element has not been taken into account by the draft guidelines which, if unaltered, risk significantly harming client outcomes as it runs counter to the widely

established and common practice of creating well diversified portfolios containing differing risk assets for investors.

Currently all client types in all distribution channels regularly utilise this proven approach to generating improved returns whilst managing risk. If ESMA does not change its view then many investors, especially retail, will no longer be able to benefit as access to many valuable and legitimate asset classes and strategies will be removed from even moderate risk investors

Furthermore, in cases of platform or execution-only services, it would be impossible to enforce and to identify any deviations from the target market.

In ALFI's view focus should rather be put in the guidelines on ensuring appropriate documentation on the reasons for which a deviation and a sale outside of the target market has occurred on those cases where the client has received advice or portfolio management services.

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?

ALFI doesn't believe any further guidance is needed in this regard.

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

ALFI questions the need to identify a negative target market for investment funds. UCITS and AIFs are via their own regulation already aimed at retail or more sophisticated investors respectively. The negative target market is de facto defined in the product rules. Limited subscription through the definition of a minimum amount of subscription also allows for the exclusion of certain types of investors. In our view there is no reason to go further and imposing additional obligations would add no value. Therefore this section of the guidelines is not relevant for funds.

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

ALFI agrees with the proposed guidelines regarding the treatment of professional and eligible counterparties in wholesale markets.

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

ALFI would like to stress once again that the investment fund industry is highly intermediated with extremely well regulated products that have their own specificities. This should be taken into account when determining guidelines. Moreover we wish to insist on the need to reach coherence between MiFID, PRIIPS and other regulations, in particular IDD which also contains target market requirements. If no harmonisation of these obligations is ensured this will result in various target markets concepts, which will cause confusion in the minds of investors and will not be to their benefit.

We would support the EFAMA suggestion to include further case studies in the final guidelines, and in particular regarding non-complex UCITS, and would suggest that ESMA also provides a list of minimum requirements to be met in this context according to different classes of products.

Finally we would like to underline that the final guidelines need to be capable of being translated into generic data for use by industry stakeholders.

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.

ALFI is not in a position to deliver specific figures as regards resources needed to implement the guidelines.

