ESMA
European Securities and Markets Authority

January 5, 2017

Consultation Paper ESMA/2016/1436
Draft guidelines on MiFID II product governance requirements

Dear Madam or Sir,

The Association of Foreign Banks in Germany welcomes the opportunity to comment on the draft Guidelines on MiFID II product governance guidelines (the "Guidelines"). We represent about 200 German entities of foreign banks and asset managers. A lot of them are active in the investment services sector and/or rely on well-functioning EU capital markets.

Two of the most important features for the functioning of cross-border capital markets are

- a regulatory framework that promotes or at least does not impede open sales architecture, i.e. the possibility of investment firms to provide access to a wide range of financial instruments issued by a variety of issuers to their clients, and
- the ability of sophisticated clients to obtain information and to choose the financial instruments they want to invest in at their own discretion.

These are, in our view, also the most important aspects to be borne in mind when creating the EU capital markets union. Investors including retail investors need access to financial products, otherwise the Capital Markets Union cannot function well.

One particularity of the German retail investment services sector is the provision of non-advisory brokerage services to retail clients, which are often offered online and provide for prompt execution of orders at very low costs (as compared to other EU countries). In our view, this is a mature financial

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market infrastructure. In connection with our answers to the questions posed in the Consultation Paper, we will provide data which evidence that in fact the vast majority of trades executed for retail investors in Germany are of a non-advisory nature, but however based on thorough appropriateness tests which ensure investor protection. We are not aware of any mis-selling in this trading context, mainly due to the fact that there is no active selling either face-to-face or by telephone.

This well-functioning market for retail investors is nevertheless in danger now if the draft Guidelines remain unchanged. Furthermore, the efforts at European level with regard to the establishment of a Capital Market Union might be thwarted. Certain aspects of the Guidelines should be amended in order to take account of the particular needs of the brokerage services, or else the provision of such services would become outright impossible. The same aspects that cause these concerns are also relevant with regard to open-architecture distribution structures. We think that providing access for retail investors to choose from and trade in a large variety of financial instruments should not be compromised.

So we hope that our concerns as expressed in our proposals set out below can still be addressed by ESMA in the process of drafting the final Guidelines. Should you have any further questions or queries, please do not hesitate to contact us.

Kind regards,

Dr. Oliver Wagner Wolfgang Vahldiek

Answers to ESMA's questions in the Consultation Paper (ESMA/2016/1436) Draft guidelines on MiFID II product governance requirements

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.

ESMA has chosen the approach to describe a general framework of categories but leave discretional flexibility to manufacturers, in order to account for specificities on a case-by-case basis. However, the result is neither standardized nor machine-readable and requires human intervention on the side of the distributor in order to understand and adapt to the target market description.

This approach causes problems on the distributors' side which we describe in detail in our answer to Question 3.

Question 2: 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.

ESMA relies on an approach that requires manufacturers to describe products on a case-by-case basis with differing criteria as regards complexity, client's needs (or what is *ex ante* perceived to be client's needs) and even the potential number of clients.

These criteria cannot be captured in a standardized way and will not result in a machine-readable format.

Please refer to our answer to Question 3 and the market data given there. A non-standardized target market description requires human intervention and evaluation for target markets at the distributor. This can potentially be detrimental on a large scale to the German retail market, because a huge part of German retail clients' orders require real-time and cost-effective execution on a non-advisory basis in whatever financial instrument they deem appropriate and they chose upon own initiative.

We would also like to add that the draft lacks a clarification that in specific circumstances a detailed target market analysis is not necessary. This applies to

- product types which are generally compatible for the mass market – a detailed target market analysis would be spare in this case –, and
- for well-defined parts of the market, e.g. for sophisticated investors with a financially stable situation who decide on own initiative in which product they invest. In this case, the investors deliberate and decide upon which financial instrument suits their needs and objectives, and a target market analysis could not influence such decision anyway. Where advice is neither requested nor given, any attempt to overrule investors' decisions might even result in clients withdrawing their order execution from MiFID firms and moving them to non-MiFID firms abroad.

Question 3: Do you agree with the proposed method for the identification of the target market by the distributor?

We broadly agree with the approach set out under para. 23 to 27 of the draft Guidelines. In particular, we agree to the distributors being required to conduct a target market analysis as regards his business model and client basis in general. In our view, an *ex ante* analysis as regards product types and client characteristics and how the firm will, as a general approach, match its services with its client basis is feasible and advisable.

However, this cannot be done on a product-by-product level (i. e. for each ISIN of products that clients will be granted access to) in the case of non-advisory execution services. The reason for this is that a firm providing non-advisory execution services acts as a sort of infrastructure granting market access. But in the light of the fact that there are millions of financial instruments traded on secondary markets, and the number of new issuances amounts to thousands per month, the conduct of an *ex ante* target market identification, for each financial instrument the clients may possibly have access to, is impossible by the sheer number.

In order to further explain this, we would like to provide data and characteristics of the German securities markets that ESMA might not be aware of yet.

There are no market-wide statistics on how many trades in financial instruments are executed for retail investors and if they are triggered as a result of investment advice or on a non-advisory basis. However, we can provide numbers on important online direct brokerage firms run by foreign banks in Germany. We are not entitled to disclose the names of the banks, because these numbers constitute business secrets. But however, by using these numbers we can conclude by way of reasonable assumptions on the market structure as a whole.

I. Market characteristics in Germany

The numbers received by our members let us conclude that the German market has the following specificities:

1. A large number of trades by retail investors is non-advisory-based.

One of the biggest foreign banks in Germany is also the biggest online bank (8 Mio clients) who offers *inter alia* online brokerage services. But due to the lack of clients' interest for advisory services, it does not provide investment advice at all, so the advisory-based trades are zero.

Another foreign bank (which has about 1.4 million clients and is one of the biggest online brokers in Germany) actually does provide investment advice to clients if they so wish. But the numbers result as follows: On average 35.000 trades are executed per day, the vast majority of which come from retail investors. But less than 0.5 per cent of the trades are advisory-based.

Altogether, bearing in mind that the market share of foreign banks in German brokerage market is estimated to be roughly about 20 per cent, we can safely assume that on a nation-wide basis several hundreds of thousands of trades are executed for retail investors every day on a non-advisory basis.

2. Real-time execution is very important for German retail investors.

The data available for us suggests that the total share of derivative instruments in the portfolios of German retail investors is low. It is presumed to be below 5 per cent on average.

This is confirmed by data from one of our big online brokerage members which states that only 2 per cent of the clients' portfolios are derivative securities (i. e. structured instruments like warrants etc.). But in contrast to that, a whopping 32 per cent of the trades executed by that online broker are in derivative instruments. This leads to the conclusion that the holding period for such derivatives is typically short and that they are price-sensitive and require real-time execution.

3. Execution costs play a significant role for retail investors in Germany.

As evidenced by the huge number of retail investor trades in Germany, execution costs play a significant role for them and should be borne in mind when drafting investor protection rules.

A normal retail trade executed with online brokers ranges between € 1.000 to 10.000 and will be executed, according to the fee structure of German online brokers, for a fee between € 6 to 20. Given the huge number of retail trades, any increase in the fee structure triggered by regulatory measures will significantly harm investor interests. We have no doubt, that a human intervention to every trade – checking its compliance with the target market of manufacturer and distributor – would easily double execution costs for the retail investor. We know the number of trades concerned, and we know the price, so we can assume that additional costs can amount to millions of Euro per day.

4. Retail investors who are clients of online brokerage firms demand access to every financial instrument traded on regulated markets, MTFs or elsewhere.

The basic services description of German brokerage firms is to provide their clients access to every market and every financial instrument traded on those markets, if the client wishes to trade in them. E. g., the client basically enters an ISIN in the online order form and, provided that the appropriateness test is passed, gets his order forwarded/executed in real time.[1]

Given the fact that millions of financial instruments exist and thousands of them are issued every month, the brokerage firm is in no position to conduct a product governance process in advance for each of the ISINs that a client can possibly wish to trade in. The reason is that the

[1] This structure will prove to be very helpful in promoting the Capital Market Union, because the issuers on SME and other markets will be able to rely on the fact that investors will have access to their financial instruments. The online brokerage model is therefore beneficial for the CMU.

clients decide on which instrument to trade, and the broker does not become aware of the decision until the very moment of the order.

5. Retail investors who are clients of online brokerage firms are reluctant to share specific information on their financial situation and investment needs/objectives.

As reality shows, retail investors in Germany are to a certain extent reluctant to share personal data with banks and investment firms. In fact, one of the main reasons of choosing direct brokerage instead of advisory-based service providers is that personal data will not be given away unhesitatingly. In the light of data protection and data reduction, we think that this client behavior should be respected.

So yet this is another reason why detailed and discretional target market descriptions by manufacturers cannot be implemented by distributors who offer non-advisory execution services. These distributors simply do not have access to client data which would allow for a matching procedure on a case-by-case basis.

II. Conclusions for the Guideline's approach to defining target markets

Distributors who do not know in advance which instruments clients are going to trade in have only two options: Evaluating the target market on a trade-by-trade basis, i. e. at the moment when the distributor becomes aware of the investor's decision which instrument he wants to trade. Or conduct a target market process for every financial instrument that is potentially available for the clients when granting the access to markets. Both options however are not feasible in a non-advisory order execution environment.

If applied on a trade-by-trade basis at the distributor conducting brokerage services on a non-advisory basis, assessing target markets on a trade-by-trade basis would require human intervention, because manufacturers' target market description will be discretional and include "free text" that is not machine-readable. As a consequence, assessing target markets at the moment of the trade would seriously impede the real-time and cost-effective execution German retail investors require. It would also multiply execution costs and seriously harm the investor's interest. Having in mind that hundreds of thousands of retail trades are executed each day, driving up costs by requiring human intervention would pile up serious amounts of costs which neither the firm nor the client can bear under the German market structure. There should be no doubt that the clients obvious need and objective of prompt execution is very important. Execution must be done at the prevailing market price at the very moment of ordering. It should not be compromised by conducting a hands-on target market analysis before executing.

Likewise, applying target market assessments *ex ante* on a product-by-product in terms of an ISIN-by-ISIN basis would also not be feasible for distributors conducting brokerage services on a non-advisory basis, because millions of financial instruments exist and thousands of them are issued every month. The brokerage firm is in no position to conduct a product governance process in advance for each of the ISINs that a client can possibly wish to trade in. If required to do so, distributors would be forced to radically diminish the access for clients to secondary

markets, which is contrary to the clients' wishes, needs and objectives and therefore counterproductive.[2]

In fact, this has a political dimension. We have doubts that the German public would accept a regulatory intervention in their personal investment strategies on this scale. It also remains to be seen if the European legislator welcomes a considerable disruption of market structures which presumably was not intended when passing level 1 and 2 provisions.

On the other hand, the Guidelines' approach is suitable for advisory services, as long as they are performed by humans, because in the course of human advisory the manufacturers target market, even if of discretionary nature, can be taken into account. Nevertheless the regulatory costs of investment advice will also (and once more) be increased.

However, there is one additional thought on advisory services: Once the market will be driven by technology and shift to online-based business models like the so-called "robo-advice", a machine-readable format of target market descriptions would be the only way to enable this kind of services. We understand that, in the area of cross-border distribution of investment funds, the Commission relies on online technologies for promoting the Internal Market, so again there are conflicting goals emerging. ESMA should not discourage online business models before consulting the Commission in this respect.

Only when offering advisory services (often connected with active selling efforts) about particular financial instruments, such target market analysis prior to order execution is possible on the level of the particular financial instrument that the client is being advised about. Nevertheless, there is even a limit to this, if the client determines on his own initiative which financial instrument he is seeking advice for, e. g. when he asks for advice on a particular instrument the advisor did not know in advance.

Again, in the case of non-advisory brokerage services,

- the assessment of target markets is impossible to be done *ex ante* on an ISIN-by-ISIN basis by assessing all financial instruments available on financial markets because of the nearly infinite number of instruments listed and/or traded and/or issued;
- likewise, the assessment is impossible to be carried out at the moment of receiving the clients' orders because the target market information of manufacturers will not be available in a machine-readable format and clients require immediate and cost-effective order execution which rules out a manual "hands-on" approach.

Our proposals to question 3:

- In para. 24, 27, 2, 30, 32, 36, 37, 46, 56, 59, 60 – or alternatively, by way of a clause in para. 39 – it should be clarified that where a distributor grants access to a wide range of financial instruments and/or financial markets in general (to clients for whom such approach is appropriate and whose needs and objectives are in line with this) and

[2] Restricting the market access of clients to a given number of well-defined financial instruments is no option, because German retail clients of brokerage services are used to demand execution services for every financial market as a whole.

therefore the distributor is in no position to determine in advance for which financial instruments it is going to receive client orders, that target market assessment may be done in a proportionate and appropriate manner for **product types or markets** instead of each individual financial instrument on an ISIN-by-ISIN basis.

- Excluding particular financial instruments even for sufficiently sophisticated and financially stable retail clients – as proposed in para. 28 of the draft Guidelines – should be strictly limited to extreme exceptions, like e. g. CoCo bonds. Para. 28 should not be understood as a requirement to assess each and every financial instrument a client might wish to trade in on an ISIN-by-ISIN basis.

- Para. 29 should clarify that the assessment of the target market by the distributor can be done with regard to products but also with regard to **types of products** where the distributor is in no position to determine *ex ante* which particular financial instrument a client is going to order in the course of the client relationship. E. g. this is the case where a distributor grants general access to financial markets but may only determine at the very moment when the investor gives the order for trading in a particular ISIN which financial instrument the client is interested in and a target market analysis before execution is impossible without neglecting the client's need and objective of immediate execution.

Question 4: Do you agree with the suggested approach on hedging and portfolio diversification aspects? If not, please explain what changes should be made and why.

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Question 5: 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?

For distributors providing non-advisory order execution services, the information gathering process described in para. 52 of the draft Guidelines is neither meaningful nor feasible. Their clients will trade in financial instruments issued by non-MiFID issuers, because the distributor provides for the market access but is in no position to know or assess in advance which financial instruments the clients might want to trade in. The near-infinite number of financial instruments concerned makes an ex ante target market assessment impossible. For details, please refer to our answers to Question 3.

Furthermore, distributors providing non-advisory order execution will not be able to enter into agreements with issuers. E. g. issuers of stocks listed on Nasdaq will not be willing to enter into agreements with each and every EU brokerage firm which provides access for their clients to Nasdaq and who might trade in the stock of that issuer.

In addition, applying para. 52-54 to distributors who offer non-advisory order execution services would as a result impede any access of clients to non-MiFID II issuances. Para. 54 explicitly provides for this consequence. We have serious doubts as to whether EU investors would accept being effectively banned from investing in the respective markets, for example foreign stock markets, by such regulatory provision.

Our proposal:

As a consequence, the application of para. 52 to 54 of the draft Guidelines should be restricted to situations where distributors want to actively promote and sell a given financial product to clients. Only in these situations a distribution agreement between distributor and manufacturer makes sense and is practically feasible.

Question 6: Do you agree with the proposed approach for the identification of the "negative" target market?

In para. 63 it is stated that under the appropriateness regime, situations might occur in which firms become aware of clients who are outside the target market but nevertheless acquire a given financial instrument. This is possible due to the appropriateness regime providing for a clear warning issued to clients, but does not impede the client to trade if he so wishes regardless of the fact that the instrument might not be suitable for him.

A firm acting like that is perfectly in compliance with MiFID provisions and clients' needs and objectives. We do not think that this situation needs further guidance and/or requirements by way of product governance regulation. The fact that a clear warning is issued to the client leaves it to the client to decide if he still wants to acquire the product and ignore that warning. The only requirement a firm may want to fulfill is to design the warning in a sufficiently clear and explicit manner, as to make the client perfectly aware of the facts. We might add that it is self-evident that a distributor should not actively advise a client to acquire a financial instrument if that instrument would fail the appropriateness test, because it would not be suitable in such a situation either.

Question 7: Do you agree with this treatment of professional clients and eligible counterparties in the wholesale market?

We do not agree with the distinction ESMA makes between elective and per se professional clients. This distinction has no grounds in level 1 and level 2 provisions.

In our view, elective professional clients can (and have the right to) be treated as "full" professional clients according to MiFID II, because the assessment of the election criteria ensures that both a comparable level of knowledge and experience and ability to understand the risks and to bear losses is safeguarded in a sufficient manner.

Question 8: Do you have any further comment or input on the draft guidelines?

1. Complex products

Several parts of the draft Guidelines assume that the more complex a financial product is, the more the distribution should rely on investment advice.[3] The rationale behind that is that clients, under normal circumstances, would need explanations and guidance on how to use the complex financial product properly.

The reality is that this concept is comprehensive for less experienced retail clients. However, it is contrary to the needs and objectives of sophisticated clients – including sophisticated retail clients – who decide to require non-advisory order execution services on an appropriateness test-basis.

In this case, and completely in line with MiFID, investment firms evaluate and make sure by requesting client information beforehand whether the client is sophisticated enough to handle the complex product or not and whether he can bear losses which may occur. In that framework, the client's need and objective to have real-time market access can and should be respected.

Therefore, the Guidelines should clarify that where an investment firm can establish by way of an appropriateness test that a client is sophisticated and financially stable enough to handle complex investment products and trade on his own initiative, he can be granted access to non-advisory execution services in those products accordingly. The introducing of a mandatory advice contrary to the client's needs and objectives, impeding real-time and cost-effective execution, should not be required.

Furthermore, it is not necessary for manufacturers to deliberate on whether the product might be suitable for non-advisory order execution for sufficiently sophisticated/solvent investors or not, because this is obvious and the level of sophistication/financial situation needed is safeguarded by the distributor's appropriateness testing process (which is in turn supervised by regulators).

In other words, a sophisticated and financially stable retail investor should not be banned from trading against his will, his needs and objectives. Clients will not accept this kind of regulatory paternalism.

2. Data gathering

In para. 33, sentence 3 should be deleted. It is not in line with Art. 6 (4) of the General Data Protection Regulation, which prohibits the use of data for purposes other than those they have been gathered for in the first place. Distributors should not be discouraged to comply with this provision. The use of data gathered through sources other than the provision of investment

[3] E.g. para. 20 and 21 of the Background Section, para. 22, 40, 45 of the draft Guidelines

services for target market assessment purposes is not allowed by level 1 or level 2 provisions yet, so it would be illegal.

3. Products for which distributors receive inducements

In our view, para. 40 of the draft Guidelines do not take into account the specific features of the German investment fund market. First, in Germany, it is possible to trade investment fund units on secondary markets (MTFs).[4] The advantage for investors is that in these markets, there are no subscription fees charged. Also, a lot of brokerage firms grant access to such secondary markets on a non-advisory execution basis. So sophisticated retail investors who are aware of such possibility get easy and cheap access to such investment funds.

Second, a lot of distributors provide access for investors to order execution with management companies on a non-advisory basis upon initiative of the clients.

However, if management companies grant inducements on an ongoing basis to the distributors for investment fund units held with them, they do not distinguish between fund units acquired at the management company or on the secondary market. This puts distributors who provide access to financial markets on a non-advisory basis to retail clients in the same situation as with all other non-advisory order execution services. As far as there is no active recommendation issued to clients, the distributor is in no position to know on an *ex ante* basis whether a client might order a fund or not, and if so, which one it might be.

As a consequence, our proposals made under Question 3 apply for the application of para. 40 of the draft Guidelines, too.

4. Non-advisory order execution: reporting to manufacturers

The basic promise of distributors conducting non-advisory order execution services to clients is that clients are provided access to every financial instrument which meets the appropriateness test and which is available in the financial markets, provided that, accordingly, the clients are sufficiently sophisticated and could bear losses if they arise. This is what clients of such distributors expect, in line with their needs and objectives.

This is a fact commonly known in financial markets and also by manufacturers. They are aware of the fact that once a financial instrument is traded on secondary markets, anyone who has access to these markets may acquire it. Therefore, the last sentence of para. 46 of the Guidelines should be deleted and para. 50 clarified. The fact that on secondary markets, clients might acquire a financial instrument, even if the manufacturer has not envisaged that kind of distribution in the first place, is normal, self-evident and by no means extraordinary. It does not warrant a reporting duty to manufacturers as they are very well aware of it anyway.

[4] This is done even without or against the will of the management company, in other words, the latter cannot influence the MTF trading of his funds.