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ESMA CONSULTATION ON DRAFT GUIDELINES ON MIFID II PRODUCT GOVERNANCE

Intesa Sanpaolo's reply to ESMA consultation paper

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

As a preliminary remark, we think that when detailing the categories for the definition of the target market, more consideration should be given to the cases when products are sold on the basis of a portfolio approach. In light of that, the categories for the identification of the target market should also include whether the product is suitable to be sold individually or as a component of a portfolio. This is particularly important as, should it be the second case, it would influence how the distributor assesses the product's risk tolerance, financial situation and time horizon as defined by the manufacturer.

To take into duly account the relationship that occurs between the manufacturer and the client, we think that the guidelines should also report point 12 of the background note – stressing that manufacturers usually don't have a direct contact with the client and thus have no detailed individual information about the client base.

On the specific list of categories we think that:

- Factor c) in the guidelines requesting the manufacturer to detail the ability and willingness of the customer to bear losses, should be amended to require the manufacturer solely to specify the amount of losses the target market should be willing to afford. In light of the fact that the manufacturer (particularly when it is a different entity from the distributor) has no direct relation with the end-client, information on the clients' ability to bear losses proves to be out of his/her reach. Therefore, the manufacturer shall be requested only to consider the willingness to bear losses when defining the potential target market.

- Factor d) on compatibility of risk/reward profile of the product with the target market should be made optional for manufacturers. The guidelines require to specify the general attitude that target clients should have in relation to the risk of the investment. However, as manufacturers and distributors often have in place very different models/approaches for the definition of risk categories, it is reasonable to expect that there will be cases where distributors won't be able to distribute the product in consistency with the categories identified by manufacturers. Requesting distributors to comply and change their models to fit with the manufacturers' seems disproportionate – as distributors' sizes may be very different, affecting their capacity to change their models. On the other hand, requesting

manufacturers to apply all the different distributors' models they have a contract with, would be extremely burdensome and inefficient.
Lastly on this point, the request for firms to use the risk indicator identified under the PRIIPs Regulation seems to us redundant and superfluous as the KID will already provides consumer with the SRI. Therefore, there is no added value in repeating such information when developing the target market. In light of the above, and the fact that "risk tolerance" is also part of the requirements already outlined under letter c), we think that the requirements listed at letter d) should be considered as optional for manufacturers.

- The categories of clients' objectives and needs should be merged - or alternatively, clients' needs shall be considered optional as additional specification of the clients' objectives. It shall be bear in mind that manufacturers don't have a direct connection with the clients and may not have sufficient information on both categories. It is worth noting also, that not all products fulfil particular clients' need, and therefore manufacturers may be unable to include information on this topic.

- Lastly, we note that para 13 of the guidelines foresee for the manufacturer the possibility to elaborate qualitative considerations in its identification of the target market. However, we worry that this would lead to divergent practices across markets. Therefore, we would welcome further guidance on the point, possibly by further detailing in Annex IV specific cases of target markers identified by manufacturers which do not perform distribution activities.

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.

We think that the approach outlined in para 18-20 of the guidelines does not take sufficiently into account the overall situation of clients' personal investments portfolio. With regard to the clients' portfolio, the guidelines should require that the identification of the target market shall be done in "an appropriate and proportionate manner, considering the nature of the investment product *as well as and the clients' need and objectives on the basis of his/her portfolio*".

Also on the product's nature, we consider important providing more details on the application of the six categories for the case of collective investment schemes – where diversification of assets is mandatory and the overall profile of the scheme has lower risk than investing in a single security. In light of that, a common approach for collective investment funds shall be defined, which allows the description of some of the categories to be more generic and reflect the regulatory ensemble for the relevant fund.

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

With regard to the identification of the target market by the distributor, we think that the guidelines are not considering sufficiently the cases where two or more firms cooperate in manufacturing a financial product – thus being considered as "co-manufacturers". This case instead, is considered under art. 9 of Commission Delegated Directive of 7/04/2016 and also in EIOPA's consultation on product governance requirements under IDD. According to the definition provided in art. 9, "manufacturing" includes both the activities of "issuance" as well as "design". However, it is common practice in the market to see those activities performed by different players - who co-manufacture the product. In order to take these frequent situations into due account, and in consistency with the approach outlined under the IDD, the guidelines should specify that under certain circumstances (e.g. design of some features of the product by a firm which is different from the issuer) it is possible that responsibilities for product governance's processes on a financial product are placed on more than one single firm – to be classified as "co-manufacturers". Therefore, the guidelines should consider the cases where responsibilities on product governance processes are placed on different firms, including the distributor – who acts as co-manufacturer. Under these circumstances, the different firms shall outline in a written agreement their respective responsibilities for the different phases of the product manufacturing. The firms involved in the co-manufacturing of the product should be disclosed to potential clients via information documents (prospectus/ KID).

Also, the method for the identification of the target market by the distributor does not properly address the issue of portfolio management. For this type of distribution strategy, the target market shall be set at portfolio level and not for individual products. In light of that, the target market requirements for financial instruments invested through portfolio management strategies shall not apply. Whereas, when the investment portfolio is distributed by a different firm from the one providing investment portfolio services, the distributor shall define the target market on the basis of the 'abstract' target market defined by the investment firm that provides the portfolio management service.

Q4: Do you agree with the suggested approach on hedging and portfolio diversification aspects? If not, please explain what changes should be made and why

We think that the guidelines lack flexibility on this point, which is instead necessary in light of current market practices. Many firms offer to their clients non-independent advice according to a portfolio approach – ensuring that the client's portfolio is overall consistent with his/her financial profile. This may lead to frequent deviations from the target market identified by the manufacturer for each single product taken as a stand-alone offer. The approach described may result in the distribution of instruments that have features that considered as a stand-alone offer would not be suitable with the client, but fit the overall financial profile of the client.

Therefore, the guidelines should provide more flexibility on deviations from the target market for investment firms providing investment advice according to a portfolio approach – acknowledging that portfolio diversification remains a fundamental tool for investor protections. In light of that,

diversification at portfolio level should be included in the target market identification (i.e. it should be allowed the possibility to assess the target market at portfolio level) and deviations should not be reported when all applicable legal requirements are in place and: i) the distributor provides the manufacturer with ex-ante information about its investment services model; ii) it adopts a "blocking suitability model" of the product's sale according to clients' knowledge & experience, and to the features of the portfolio, in order to protect the best interest of the client and his/her investments; iii) there is ongoing suitability assessment; iv) ex-ante disclosure of the service model is provided to the client. If these safeguards are in place, there is no reason why a deviation from the target market should not be allowed – also for cases where a conflict of interest exists (e.g. self- placement). Existing provisions on investment advice, complemented by the operating model described, would provide effective tools to manage conflict of interests and promote portfolio diversification. With such safeguards in place, the outright ban on distributors to deviate from target market in cases of conflict of interest should be removed.

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?

We agree with the proposed guidelines. In order to ensure legal certainty we think it would be important to further clarify that distributors are not required to enter into additional formal agreements with managers of UCITS and AIFs, provided that they may ask for additional information not included in the KIID or Prospectus.

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

In some cases, the negative target market can be simply identified as all customers that are not included in the positive target market. For these cases, we would recommend to allow for a simpler description.

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

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

In order to ensure legal certainty, we would encourage ESMA to provide more clarity on the application of the definition of "distributor" as provided in the guidelines in order to stress that the distributor is the entity that maintains a direct relation with final investors. As per the definition of distributors, we would not only refer to MiFID (i.e. *the firm that offers, recommends or sells an investment product*) but also ESMA's good practices for product governance arrangements (ESMA/2014/ saying that "in practice*, within the supply chain of an SRP the distributor is the last link*: *i.e. it is the firm that has the direct contact with the investors, to whom it sells the SRP issued either by itself or by other firms*")

In particular:

- According to such definition of distributors, it should be clarified that trading on anonymous secondary markets via trading venues or OTC negotiations performed by the manufacturer or other actors on behalf of the final clients, shall not fall into the definition of "distribution".
- Likewise, with regard to the requirements related to the identification of the target market by distributors, it should be clarified in the guidelines, that investment firms which are involved in the reception and transmission of orders and grant to clients access to financial products which are either issued by 3rd parties with no contractual relationship with the firm, or available on the secondary market; shall not be considered "distributors" and are not in the scope of product governance rules. This is also consistent with MiFID II Delegated Directive and its obligation on distributors.
- Lastly, we note that the definition does not consider the cases where more entities are contributing to the manufacturing of the product. Thus, co-manufacturing products. When the definition of co-manufacturing applies, the respective responsibilities of the firms involved should be defined in a written agreement - referencing the various phases of the process. Under such circumstances, information documents on the co-manufactured financial product (i.e.. Prospectus, Key Information Document) should disclose to perspective clients which are the firms involved in the manufacturing processes of the product and their respective responsibilities in relation to its different features.

With regard to the entry into force of the guidelines, we would call for more clarity. Notably:

- On the basis of the definition of distributor as the entity that has direct contact with the end investor, the guidelines should clarify the requirements for products that have been manufactured before 3 January 2018 and which have not reached their maturity date yet. Bearing the definition in mind, we assume that products distributed in the primary market before January 2018 whose maturity date hasn't occurred yet, do not require the manufacturer to assess the potential target market. Neither this applies to products' review, inasmuch as they are not products subject to "distribution" – unless the manufacturer undertakes a new "distribution" process/agreement.

- We also call on ESMA to clarify in the guidelines how to harmonise the requirements for the manufacturer to identify the potential target market under MiFID II with the requirements under the PRIIPs Regulation to provide in the Key Information Document (KID) a description of the type of retail investor to whom the PRIIP is intended to be marketed (as per art. 8. 3c EU/1286/2014 and art.2.3 Commission's Delegated Regulation 30/06/2016).

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.

On the manufacturing side, we would need at least a KYC office of 3 / 4 people to mantain the current distrubution level.