European Securities and Markets Authority (ESMA)
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Consultation Paper

Draft guidelines on MiFID II product governance requirements

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Response by:

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Introduction

The European Investors' Association (**"European Investors"**) is a pan-European association that was launched in 2015 and that promotes the interests of retail investors, both in the regulatory domain as well in corporate litigation proceedings and shareholder disputes. European Investors believes it is important that investors enjoy sufficient legal protection and that legislative and regulatory measures contribute to a well-functioning capital market. We are therefore always interested and prepared to comment on consultations initiated by European and national legislators and regulators, especially since retail investors are often not in the position to defend their own interests on an individual basis.

It is with great interest that European Investors has taken note of ESMAs draft guidelines on MiFID II product governance requirements (**"draft guidelines"**). The new product governance rules constitute an indispensable part of the strengthened protection regime under MiFID II, of which European Investors has been a strong advocate. The rules, of which the obligation to identify a target market is an essential component, requires additional steps to be taken by manufacturers and distributors to ensure that investment products are only offered in the interests of clients. European Investors very much welcomes the draft guidelines which provide much-needed clarifications to the target market identification.

However, European Investors does have some concerns: i) will distributors retain the possibility to provide personal recommendations based on individual facts. Such individual facts (e.g. portfolio considerations) might necessitate deviations from the target market; ii) will distributors remain sufficiently incentivised to find the most suitable product for their clients, instead of settling with a product simply because the client is within the target market and iii) to what extent will the extensive obligations for manufacturers place responsibility where it does not belong, away from the distributor.

Questions in the Consultation Paper

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

Broadly speaking, European Investors agrees on the proposed list of categories in the draft guidelines (p.10). We do not have any suggestions for additional categories. However, we do have some minor but important comments regarding some of the proposed categories. Further comments that are specific to the target market identification of the distributor are made in response to question 3.

Type of client to whom the product is targeted:
The MiFID II distinction between professional clients, eligible counterparties and retail clients is a valuable one. However, some of the additional descriptions suggested by ESMA are already covered by the other categories. For example, "sophisticated clients" would already be covered by category (b) on knowledge and experience. It could be asked whether these additional descriptions, if already covered by other categories, have added value or would only cause confusion.

Risk tolerance and compatibility of the risk/reward profile of the product within the target market:
The name of this category refers to the risk/reward profile of the product. Normally, the risk tolerance of a client is assessed independently of reward considerations. The appropriate risk/reward profile for a client is normally determined after assessing other factors first, including risk tolerance but also the client's ability to bear losses and his objectives, particularly his financial goals and time horizon. European Investors would suggest to include risk/reward profile under category (e) on client objectives.

Client needs:
European Investors would like to ask ESMA to clarify the category of 'client needs'. Looking at the case studies in Annex 4 of the draft guidelines, it is not clear to us what this category aims to capture and what exactly the difference is with 'client objectives'. The draft guidelines refer to "aspects of the investment and expectations of the targeted clients" (p. 24). If these aspects and expectations relate to the client's financial objectives and the overall strategy he or she follows when investing, then these should in our view not be mentioned separately under 'client needs' but under 'client objectives'.

For example, in case study 1, it is stated under 'client needs: "six year term investment horizon, and expectation that, at expiry, none of the stocks will be worth less than 50% of the initial valuation" (p. 37). European Investors would think it makes more sense to mention this information under 'client objectives'. Also, the "expectation that, at … the initial valuation" should in our view be referred to under 'financial situation with a focus on the ability to bear losses' and under 'risk tolerance'. Generally speaking, European Investors thinks the category 'client needs' should only be used for specific aspects and expectations that are not adequately covered by other categories, such as 'ethical investment'.

Finally, European Investors finds it peculiar 'age' is mentioned as a separate factor under 'client needs'. Age in itself is not a need. It is merely a fact that might influence the client's knowledge and experience, ability to bear losses (or better said: his ability to make up losses after they have been incurred), and objectives (in particular, his investment horizon).

<u>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.</u>

European Investors agrees with the suggested principle that the more complex a product is, the more detailed the description of the target market and of each category. Although it may also be that some products are so complex or risky (e.g. contracts-for-difference, binary options, and spread bettings) that they are not compatible with any retail client. In such case, one could state in category 1 that the product is meant for professional clients and eligible counterparties only. In such case, any further reference to retail clients in the remaining categories is not necessary which might make the descriptions less detailed than for products that are compatible with specific types of retail clients.

A further comment relates to products that are traded on secondary markets, such as shares, bonds and exchange-traded funds (ETFs). There are a number of questions, as also expressed within the SMSG Group, in regards to the treatment of such products, for example: who is the 'manufacturer' in case of shares? How long does the obligation of the 'manufacturer' last? Who is considered as the 'distributor'? And what are distributor's responsibilities in case of non-EU instruments? We would like to ask ESMA to include additional case studies on shares and UCITS in Annex 4.

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

As specified in the draft guidelines, distributors should use the same list of categories used by manufacturers. European Investors is of the view, however, that distributors, when identifying the target market, should take into consideration that part of the client's portfolio which is already allocated and on which no recommendations are given (see also our comment to Q4).

For example, suppose that a client is described as 'defensive' in terms of risk tolerance. This would normally mean that this client is outside of the target market of a product with a potential capital loss of 100%. However, the money that the client considers to invest in that product constitutes only 5% of his total portfolio; the remainder of his portfolio is invested in bonds and cash to which the volatility of the product is not correlated. The product might in such case still be compatible (provided it serves a specific need of the client that is not served by other less-risky products). Risk tolerance is a concept that should be applied at portfolio level.

Relation between manufacturer and distributor: target market identification

The draft guidelines state that "it is regarded as good practice for distributors to generally respect the target market by the manufacturer" (p. 27). While European Investors agrees, we would still like to emphasize very strongly that the product governance obligations for manufacturers, and the target market identification in particular, should in no way take away responsibility away from the distributor. Regardless of what the manufacturer deems to be an appropriate target market, it is up to the distributor to make the final decision of whether to recommend a product to a particular client or not. This includes that if the distributor is of the view that the target market should be broader/narrower than the manufacturer's target market, the distributor should be encouraged to define it differently and communicate this decision to the manufacturer.

When misselling occurs, the distributor should not be in the position to safeguard itself from liability by referring to the manufacturer's target market. The distributor should carry full responsibility for its decisions, unless the manufacturer has provided misleading or omitted product information to the distributor. In that case, the distributor has a claim against the manufacturer and clients a deferred claim.

<u>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.</u>

European Investors is of the view that the draft guidelines should not be overly restrictive with regards to the limitations it imposes on recommending products outside of the target market, provided that such deviations are warranted by a suitability assessment performed by the investment firm. While European Investors agrees that such deviations should be documented properly by the distributor, we do not share ESMAs view that such deviations "should not occur on a regular basis" (p. 10).

Paragraph 4 of the draft guidelines state that: "MiFID II clearly notes that the requirements on product governance apply without prejudice to any assessment of appropriateness or suitability to be subsequently carried out by the firm in the provision of investment services to each client, on the basis of their personal needs, characteristics and objectives" (p. 4).

In our view, this should be taken to mean that the identification of a target market is not intended to waive the firm's obligation to perform a suitability assessment in accordance with Article 26. If a client is within the target market of a product, it does not mean the client should be recommended that product. Vice versa, if a client is outside of the product's target market, it does not mean it might not be in his best interests. In other words, the ultimate decision to recommend a product or not should be solely based on an assessment of the client's *personal* needs, characteristics and objectives.

The possibility to deviate from the target market is critical since "the perspective of the target market assessment is the individual product" (p.10). Within a wider portfolio approach, it might be in the best interests of a particular client to be recommended a certain product even though the client is outside of the target market of that product (e.g. for hedging or portfolio diversification purposes) or not be recommended a certain product even though the client is within the target market (e.g. strong volatility correlations with the rest of the client's portfolio). We fully agree that when recommending products outside of the target market, care is warranted. For example, the product concerned should only make up a limited percentage of his or her portfolio.

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

European Investors would like to ask ESMA to clarify further the concept of 'negative' market. Where should one draw the line between the 'negative' market of a product (inside of which distribution should be a rare occurrence) and the area between the positive and the 'negative' market (inside of which distribution could be justified by the individual facts but should not occur on a regular basis)?

In the case studies in Annex 4, the 'negative' target market merely seems to be a negation of the positive target market, meaning there is no area between the positive and the 'negative' target market. We would like to suggest to ESMA to also include a case study in which such area does exist and to present examples of individual facts that might justify the distribution of the product concerned to clients that fall in the area between the positive and the 'negative' market.

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

European Investors wishes to make some final comments regarding distribution strategy, one of which relates the manufacturer's obligation to take reasonable steps to ensure that the financial product is distributed to the identified target market. This includes 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, that he proposes the type of investment service and, in case the product is deemed appropriate for a sale without advice, specifies the preferred acquisition channel and, if relevant, specific design features of the channel.

Again, as a reiteration of the concerns we expressed earlier, European Investors would like to emphasize that the primary responsibility to ensure the financial product is distributed in an appropriate manner is with the distributor. The distributor knows and should know best what guidance its clients might need.

Lastly, European Investors expects that the majority of products will likely be sold both with and without advice. Even products with a narrow positive target market will continue to be sold execution only (albeit with appropriateness test), to target sophisticated retail clients that do not use advice. European Investors sees a risk that also the less sophisticated clients who are told by their adviser that they are outside of the target market will simply go to execution-only, take the mandatory but non-binding appropriateness test, ignore the warnings, and also purchase the product without advice.