

MiFID II Product Governance Requirements

Morningstar Submission to ESMA
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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.

Morningstar, Inc. welcomes the opportunity to comment on the draft guidelines on the MiFID II product governance requirements. In general, Morningstar believes that the six categories ESMA enumerated are comprehensive and appropriate, and the draft guidelines provide a clear framework for categorizing financial instruments. We believe that the industry will be able to take the guidelines and create a level of standardization to allow investors and distributors to easily search for applicable products with a common taxonomy. We have suggested a possible taxonomy in the appendix to this letter.

In particular, we applaud ESMA for including the “ability to bear losses” in the guidelines as this capacity to bear risk can be objectively measured based on an individual’s assets and goals. However, we would like to note that basic risk taxonomy ESMA suggests for client’s attitudes about risk—balanced, conservative, risk oriented—is highly subjective. Further, the risk of a single investment may well be balanced or hedged with another, so assessing risk tolerance in the context of a single investment may not be helpful. We believe the taxonomy we have suggested in the appendix for ability to bear losses (the investor seeks to preserve capital, can bear losses, or can bear losses beyond the investment amount) makes the most sense for product distribution.

We also think that the knowledge and experience discussion may not help the industry identify the proper target market. For example, four broad categories of target market experience such as no experience, informed investor, professional, or specialist could measure the amount of a priori knowledge an investor would need, rather than focusing on years of experience. We have defined these terms in the appendix to this comment letter.

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 agree. For example, we think distributors would target most Undertakings for Collective Investment in Transferable Securities (UCITs) or Non-UCITS Retail Schemes (NURS) at retail investors. More exotic investments, such as Specialized Investment Funds (SIFs) would exclusively serve professionals.

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

We agree with this approach and believe it will be incumbent on industry to standardize a taxonomy to identify the target market. In an annex to this letter, we include a possible taxonomy to help illuminate how we think target market identification will play out.

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.

Yes, we agree.

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?

No comment.

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

Yes, agree that there will be products that are typically inappropriate for a negative target market, and this framework will provide more flexibility to distributors around the positive target market.

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

No comment.

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

We have attached an annex with a possible taxonomy that we believe would meet the guideline's goals.

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.

Although costs are hard to estimate, we believe that a standardized taxonomy will help minimize costs across the industry.

About Morningstar

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Appendix 1: Possible taxonomy that we believe would meet the guideline's goals, based on drafts produced by the European Fund and Asset Management Association

Type of client

Retail

Professional

Eligible counterparty

Should instruments that are targeted at institutional/Professional clients due to fees charged , even though the underlying instrument would be suitable for a retail client, be marked as professional

Expertise Required

Basic – Is the product described such that an average execution only investor can make an informed investment decision?

Informed - Is the product described such that an informed execution only investor can make an informed investment decision?

Expert – Is the product described such that a competent advisor could enable an average retail investor to make an informed decision

Professional only – Product only suited to professional investors.

Ability to bear losses

The investor seeking to preserve capital or can bear losses to a level specified by the product structure

Investor can bear losses

Investor can bear losses beyond investment amount

Usage

Solution of a portfolio

Core or component of a portfolio

Hedging

Speculation

Other e.g. Sharia, Ethical, Tax management

Return profile

Capital preservation

Growth

Growth & Income (Morningstar Addition)

Income

Other

Access

Ready Access normal market conditions

Ready Access with restrictions

- Morningstar believes this would need to be defined as more than a de minimus amount or general trading cost.

Access uncertain

Intended Distribution Channel

Execution Only

Execution Only (with appropriateness)

Advised Retail

Portfolio Management