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Rome, 4th January 2017

ESMA – European Securities and Markets Authority
103 Rue de Grenelle
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France

Our ref: 11/17
Your ref: ESMA/2016/1436

Assogestioni's Draft Reply to ESMA's Consultation Paper on Draft Guidelines on MiFID II product governance requirements

Assogestioni[1], the Italian Investment Management Association, welcomes the opportunity to respond to ESMA's Consultation Paper concerning Draft Guidelines on MiFID II product governance requirements.

We would like to express our appreciation for the work done by ESMA to identify target market guidelines: this is an important way for ensuring the common, uniform and consistent application of the MIFID II product governance requirements.

We also agree with the benefit to provide examples in order to explain some areas firms might like to consider when identifying the target market. In this perspective, we believe that it could be very useful to have further guidance on how the target market assessment for collective investment schemes (UCITS and AIF) would look like. As the target market criteria will be used in the information exchange between a vast number of manufacturers and distributors across Europe, it is important that firms are able to work with information which are standardized as far as possible. To this end, notwithstanding UCITS and AIF managers are outside the scope of MiFID II, we propose a common approach for collective investment schemes (UCITS and AIF), taking into account the specific nature of these investment products (please see Annex 1). We believe that an identification of a common taxonomy would make the process at manufacturers' and distributors' level more efficient and comparison between different manufacturers and different distributors would be easier.

Nevertheless, we would like to draw ESMAs' attention to the following issues, which we deem very crucial for the industry.

(i) Assogestioni believes that a number of specific improvements need to be made throughout the proposed guidelines in order to ensure a clear division between

[1] Assogestioni represents the interests of the Italian fund and asset management industry. Its members manage funds and discretionary mandates around EUR 1.900 billion (as per October 2016).

the responsibility of the product manufacturer and distributor, as well as, a clear distinction between the target market identification and the suitability tests (where applicable).

(ii) Assogestioni disagrees with ESMA's suggested approach on hedging and portfolio diversification aspects. We believe that when the product is sold not on individual basis but as part of an investment portfolio, the diversification at portfolio level should be an explicit criterion included in the target market identification: this would avoid a deviation (even if permissible) with the positive target markets provided by manufacturer (please see Q1 and Q4). Diversification is a significant aim for an investor's investment portfolio, which should be strongly supported by ESMA through these guidelines <u>and not be limited</u>.

(iii) Assogestioni also strongly opposes ESMA's interpretation that individual portfolio management is a form of product distribution (par. 43 of the draft guidelines). In particular, it should be clear that target market does not apply to financial instruments invested through portfolio management. The service of portfolio management (like the management of collective investment schemes) reduces the need for the client to understand the characteristics of every single asset composing the investment portfolio. In such situations a financial intermediary with specific competences makes the investment choices on behalf of the client, guaranteeing a continuous coherence between the investment choices and the investment mandate, in the client's best interest (please see Q3).

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.

Assogestioni generally agrees with the list of categories that manufacturers should use as a basis for defining the target market for their products. Nevertheless, we would like to draw ESMAs' attention to the following issues.

(a) The target market and the portfolio approach

As anticipated, we believe that when the product is sold not on individual basis but as part of an investment portfolio, the diversification at portfolio level should be an explicit criterion included in the target market identification of manufacturers and distributor: this would avoid a deviation (even if permissible) with the positive target markets provided by manufacturer (please see Q4).

In this perspective, we believe that the draft guidelines should envisage that: (i) the manufacturer should define the "usage" of the product and, in particular, if it is suitable to be sold as an individual product and/or as a component of a portfolio; (ii) in the case of portfolio approach, the distributor shouldn't be forced to take into consideration the financial situation, product's risk tolerance and time horizon defined by the manufacturer, but in correlation with those existing at portfolio level (please see Q4).

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(b) The list of categories

Notwithstanding the above, are reported below further considerations on the specific categories that manufacturers should use as a basis for defining the target market for their products:

(i) *type of clients to whom the product is targeted*: despite the draft guidelines refer to the "possibility" for the manufacturer to use additional descriptions to refine the categorization of the clients, we strongly believe that ESMA should not advocate additional client sub-categories, beyond the MiFID II client categorizations ("retail client", "professional client" and "eligible counterparty"). Since the manufacturer does not know the final client, further classification may be possible only by the distributor;

(ii) *clients' objective & clients' needs*: we would consider them jointly because product manufacturers do not have a direct client contact, therefore they should be allowed to merge the clients' objective and clients' needs categories into a single category. If this propose couldn't be accepted, it must be clarified that not all products will have specific features or seek to address particular clients' needs (such as green, ethical investment, etc.). This conflicts with the suggestion in para. 14 of the draft Guidelines that "manufacturers should not leave out one of the six below mentioned categories." This statement should be amended to acknowledge that the outcome of the target market assessment may result in an "empty" entry for this category.

<u>With regards to the other categories, please consider the approach described in Annex 1, that we have defined taking into account the nature of the collective investment scheme (Q2)</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.

Assogestioni agrees with the approach proposed in paragraphs 18-20 of the draft guidelines on how to take the products' nature into account.

In this context, Assogestioni believes that the guidelines should provide specific examples for the application of the six categories, <u>taking into account the nature of the collective investment scheme</u>. In fact, unlike other investment product, investors in collective investment funds benefit from mandatory diversification of assets, as well as the assurance that the fund's assets are held at an independent custodian institution. Because fund's assets are invested in an as broad spectrum of securities as possible, a fund generally involves a lower risk than investing in a single security.

In particular, we believe that for collective investment funds: (i) a common approach could be defined; (ii) the description of one or more of the six categories may be more generic and reflect regulatory ensembles, depending of the type of collective

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investment funds (non complex UCITS, complex UCITS, AIF). To this end we propose the approach described in Annex 1.

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

In general we agree with the proposed method for the identification of the target market by the distributor.

However, we strongly opposes ESMA's interpretation that individual portfolio management is a form of product distribution (par. 43 of the draft guidelines).

First of all, it is important to underline that the target market of a portfolio management would need to be set on portfolio level and not for the individual product. In particular, it should be clear that target market does not apply to financial instruments invested through portfolio management. The service of portfolio management (like the management of collective investment schemes) reduces the need for the client to understand the characteristics of every single asset composing the investment portfolio (on this point, see also ESMA "Guidelines on certain aspects of the MiFID suitability requirements", paragraph 35(b)). In such situations a financial intermediary with specific competences makes the investment choices on behalf of the client, guaranteeing a continuous coherence between the investment choices and the investment mandate, in the client's best interest.

Secondly, and consequently, although we understand that manufacturer product governance provisions applies only in relation to the product and not also to the services provides, we believe that in the case of investment portfolio management, the investment firm that provides the service should apply the manufacturer product governance provisions to the portfolio management. So, when the investment portfolio is distributed by a firm other than the investment firm that provides the investment portfolio service, the distributor should define the target market of the service taking into account the "abstract" target market defined by the investment firm that provides 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.

As anticipated in the first section of this letter and in Q1, Assogestioni disagrees with ESMA's suggested approach on hedging and portfolio diversification aspects. We believe that when the product is sold not on individual basis but as part of an investment portfolio, the diversification at portfolio level should be an explicit criterion included in the target market identification: this would avoid a deviation (even if permissible) with the positive target markets provided by manufacturer. Diversification is a significant aim for an investor's investment portfolio, which should be strongly supported by ESMA through these guidelines <u>and not be limited</u>.

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Since the target market is focused on individual products and their characteristics and since investment advisor are focused on providing investment advice based on a client's portfolio of instruments, there is bound to be a discrepancy between these two regimes or processes. In this case, in order to avoid a deviation with the positive target market provided by manufacturer, we believe that it should be recognized the possibility to assess the target market at a portfolio level. This approach appears to be in line with what is provided in ESMA's Consultation Paper where it states that "*In such instances, if the distributor has a thorough knowledge of the characteristics and circumstances of its client base, it could be possible for the firm to identify from the beginning more than one target market of end-clients, each of them characterized by different objectives or needs, rather than having to consider and justify the 'deviation' from one single, more generic target market*." (page 11 paragraph 34).

In this way, if the product is suitable for the client at portfolio level, the situation <u>should not</u> be justified by the individual fact of the case, and <u>could occur</u> (also) on a regular basis. <u>Consequently, no report needs to be delivered by the distributor to the manufacturer and no documentation should be included in the suitability report (where applicable)</u>.

In any case, we would like to underline that MiFID II require distributors to report information on sale outside the manufacturer's target market, and therefore, sales within the "negative target", and <u>not also information on sales within "grey" target market</u>, which is not considered by MiFID II.

Finally, we consider it essential that the (revisited) approach on hedging and portfolio diversification also feature in the final Guidelines themselves (and not <u>only</u> within the "background" on the draft guidelines).

Q.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?

We completely agree with the statement that the information disclosed in compliance with the Prospectus Directive, the Transparency Directive, the UCITS Directive or the AIFM Directive may be accepted by the distributor to carry out its target market assessment. In this perspective, we ask to clarify that the distributors should not have to enter into any additional formal agreements with UCITS and AIF managers (without prejudice for the distributors to request to managers the other relevant information that are not included into the KIID/KID or Prospectus).

Q.6 Do you agree with the proposed approach for the identification of the 'negative' target market?
Notwithstanding our comments into Q4, we believe that the negative target market <u>should not be described as a "contrary" of the "positive" target market</u>. In particular, we believe that identification of the negative target market should be done considering the relevance of each category in relation to the type of product. In this

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perspective we agree with ESMA's approach that "*when assessing a potential negative target market, the number and detail of factor and criteria will depend on the nature, especially the complexity of the risk-reward profile, of the product*". In this perspective we believe that in the case of no complex UCITS should not be a negative target market.

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

No comment.

Q.8 Do you have any further comment or input on the draft guidelines?
In relation to the obligation of the distributor to report information on sales outside the target market, we believe that a set of standard points of information are needed. Otherwise we could run the risk of a very fragmented approach across Europe with divergent process and quality.

Q.9 What level of resources (financial and other) would be required to implement and comply with the Guidelines (market researches, organizational, 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 organization and the nature, scale and complexity of the activities of your institution, where relevant.
No comment.

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All.: c.s.

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Annex 1

A) Criteria of Identification of the potential target market of UCITS/AIF

1. Type of client at whom the product is targeted which distinguishes between:

Retail | Professional | Eligible Counterparty

2. Investor Knowledge and experience: product manufacturers should use such a category, depending on the nature of collective investment fund:

Basic | Informed | Expert

- **Basic:** basic knowledge of how the product works.
- **Informed:** knowledge of how the product works and knowledge of product features**.**
- **Expert:** solid knowledge of how the product works; solid knowledge of product features; experience of how the product work.

3. Financial situation with a focus on the ability to bear losses: This criteria is relevant only when the product is sold individually.

Product manufacturers should use the ability to bear losses criterion to categorize their products into two broad categories:

Bear minimal loss of capital or only to level specified | Bear losses

4. Risk tolerance and compatibility of the risk/reward profile of the product with the target market: This criteria is relevant only when the product is sold individually.

Product manufacturers should use the risk indicator stipulated in the KIID/KID. If no SRRI is provided, product manufacturers should use the following categories:

Low | Medium | High

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5. Clients' objectives & client needs: product manufacturers should use the following sub-categories:

5.1 Return profile

Preservation | Growth | Income | Other

- **Preservation:** product whose investment aim is capital preservation. It need not imply a structural protection of capital**;**
- **Growth:** product whose investment aim is capital growth;
- **Income:** product whose investment aim is income provision;
- **Other:** this category is suited to a product offering a combination of capital growth and income, or that seek to provide a specific return profile (e.g. liability matching, speculation, etc.) or that adopt particular investment strategies.

5.2 Financial product's time horizon: this criteria is relevant only when the product is sold individually.

Short Term | Medium Term | Long Term

5.3 Usage: product manufactures should indicate the preferred use of the product:

Single Investment | Component of a Portfolio

- **Single Investment**: product can be sold as a single investment
- **Component of a portfolio:** product can be sold as component of a portfolio.

Distribution channel: product manufacturers should indicate the preferred distribution channel:

Execution-only without appropriateness test (retail) | Execution-only with appropriateness test (retail) | Advised (retail) | Portfolio management (retail) | Non-retail

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B) Illustrative examples and case studies related to the application of the identification of target market of UCITS/AIFS.

Case study 1 – No complex UCITS

Product

Europe Equity Fund

Target market

1. Type of client: retail clients
2. Investor Knowledge and experience: basic knowledge of how the product works
3. Investor's financial situation: ability to bear losses
4. Risk tolerance and compatibility of the risk/reward profile of the product with the target market: SRRI KIID 5
5. Client objectives & needs:
   - Return profile: Growth
   - Time Horizon: Long Term
   - Usage: single investment/component of a portfolio
6. Clients who should not invest (the "negative target market"): no negative target market
7. Preferred distribution channel: all types of distributions channel.

Case study 2 – complex UCITS

Product

Structured UCITS

Target market

1. Type of client: retail clients
2. Investor Knowledge and experience: Informed (knowledge of how the product works and knowledge of product features)
3. Investor's financial situation: ability to bear losses
4. Risk tolerance and compatibility of the risk/reward profile of the product with the target market: SRRI KIID 6
5. Client objectives & needs:
   - Return profile: Growth
   - Time Horizon: Long Term

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- Usage: single investment/component of a portfolio

6. Clients who should not invest (the "negative target market"): clients lacking the ability to bear losses on the very short term (in case of single investment) clients who are seeking single investment (in case of component of a portfolio)
7. Preferred distribution channel: execution only with appropriateness/advice/portfolio management.

Case study 3 – AIF

Product

Private Equity Fund

Target market

1. Type of client: retail clients
2. Investor Knowledge and experience: Expert (solid knowledge of how the product works; solid knowledge of product features; experience of how the product works)
3. Investor's financial situation: ability to bear losses
4. Risk tolerance and compatibility of the risk/reward profile of the product with the target market: High
5. Client objectives & needs:
   - Return profile: Growth-Income
   - Time Horizon: long term
   - Usage: Component of a portfolio
6. Clients who should not invest (the "negative target market"): clients who are seeking single investment
7. Preferred distribution channel: advice/portfolio management.

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