



## ADVICE TO ESMA

### Response to ESMA's Consultation Paper on MiFID II product governance

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#### I. Executive summary

*The SMSG's overall view of these guidelines is positive. The guidelines provide guidance and establish a framework to define the target market for investment products under MiFID II and in doing so, reduce the risk of miss-selling. At the same time, they are not overly complicated.*

*Nevertheless, the SMSG has some focused remarks. A major issue refers to the respective role of distributor and manufacturer and the communication between both. We are concerned that some of the guidelines are feasible within the context of a small market where "everyone knows one another" (distributors and manufacturers), but are more difficult to implement in the context of a large market. This would be most regrettable, as the guidelines should facilitate a European Capital Market Union, rather than provide barriers for it. Several of our remarks, in particular with regard to distributors and manufacturers, reflect this concern.*

*A second remark refers to assets which after an initial public offering, trade only on a secondary market (example: stocks). The SMSG considers that it would be very helpful if the guidelines provided clear guidance on the responsibilities and treatment of such instruments and illustrate this with a clear example. In doing so, differentiation between products could be needed (stocks, ETF's...). It should also be specified how long the responsibility lasts (only at stage of initial public offering?).*

*More generally, the SMSG proposes that ESMA rephrases its guidelines to make sure that execution-only and execution under appropriateness remain workable. In this context, the SMSG refers in particular to the position of brokers. Also, it expresses the concern that the guidelines should not have as unintended side-effect that the potential for corporates and SME's to raise capital on the public equity markets becomes more burdensome. In the context of execution-only and execution under appropriateness, a guiding principle could be that the target market guidelines should not have more restrictive consequences than the existing "know your client" requirements.*

*A fourth remark refers to the dichotomy of product approach versus portfolio approach. The members of the SMSG share the concern that a portfolio approach should remain possible. However, at the same time they share the concern that the degrees of freedom provided to enable this portfolio diversification should not be abused to facilitate miss-selling. The SMSG proposes: (i) that the final guidelines are clear with regard to the perspective expected from the manufacturer: should the manufacturer define the target market from a single-product perspective or from a portfolio perspective; (ii) that the guidelines on the extent of selling outside the target market correlate to this perspective. The SMSG also discusses different possible approaches that could be envisaged.*

*The SMSG also points at the fact that many asset managers, "manufacturers" of UCITS and AIF's, fall outside the scope of MiFID II and hence are not subject to these guidelines. The SMSG proposes that this is remedied once it comes to an update of level 1 legislation (UCITS, AIFMS). However, as this is unlikely to*

occur in the timespan available for the implementation of these guidelines, the SMSG proposes that ESMA looks at possible mitigating approaches: (i) encourage manufacturers outside the scope of MiFiD II to determine the target market as a service to their distributor; (ii) use the target market description on the PRIIPs-KID as a starting point within which the distributor further narrows the target market.

Finally, with regard to implementation costs, we consider a critical issue to be the requirements on how distributor and manufacturers are to communicate. This is also related to how compliance with the guidelines will be monitored. If a common cross-border ICT platform is to be established, encompassing distributors and manufacturers, the ICT costs would be huge. While there will also be training costs, in particular for sales and advice staff, we do not believe these to be disproportionate, as the proposed criteria are not overly complicated. Nevertheless, there is a risk of a peak load coming together as MiFiD II approaches implementation. For this reason, it would be good that the final guidelines are in place as soon as possible.

With regard to implementation, we would also like to point at a possible source of confusion. The PRIIPs-KID requires a definition of target market as well. However, the format of the PRIIPs-KID does not allow the target market to be defined with similar granularity as the MiFiD II product governance guidelines require. To remove all possible misunderstandings, we would suggest that the ESMA guidelines are more explicit on the alignment of (i) product governance target market definition and (ii) requirements to indicate target market on publicly available information, in particular PRIIPs-KID, taking into account the need of compactness of the PRIIPs-KID.

Apart from the remarks above, we also have suggestions regarding the clarity of the language.

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## II. Background

1. On 5 October 2016, ESMA published a consultation paper on “Draft guidelines on MiFiD II product governance requirements”, pursuant to the product governance requirements laid down in Articles 16(3) and 24(2) of MiFiD II, as well as in Articles 9 and 10 of the MiFiD II Delegated Directive. These draft guidelines mainly addressed the target market assessment, as this aspect was identified as the most important one for ensuring the common, uniform and consistent application of the above-mentioned rule. Within the SMSG, a working group was established to comment on these guidelines. This advice reflects the discussions of the working group as well as the issues raised in the plenary session of 10 – 11 November 2016.

## III. Comments on the different questions in the consultation

**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.**

2. Irrespective of the categories as such, the SMSG points at the need to avoid misinterpretations and misunderstandings. Differences in national or local usages may result in concepts being interpreted differently (see also point 5 of this advice). For these reasons, it is important that the concepts used by the manufacturer in defining the target market are clearly defined. On the long term, it would be good that ESMA considers establishing a common conceptual framework and common definitions. However, this seems to be an endeavour, which realistically speaking, cannot be achieved on the short term. We therefore suggest, that for the time being, **the guidelines state the need for the manufacturer to clearly define the concepts that are being used.**
3. One of the categories is “risk tolerance and compatibility of the risk/reward profile of the product with the target market.” This category mixes different concepts. First of all, there is the element of “risk tolerance” of the client. This surely is a relevant element in defining the target market. Related to that,

but not the same, are the “risk/reward expectations”. This is equally important, but it is different from “risk tolerance” as it also includes a reference to the potential reward. Thirdly, there is the “risk/reward profile of the product”, which is one of the relevant characteristics of the product (alongside other characteristics, such as complexity). It is obvious that the product characteristics and target market should be aligned. However, from a semantic point of view, we suggest that this alignment is done after the six categories are considered in their wholeness, possibly balanced off against one-another, and not isolated for one of the six categories as is done by the wording: “risk tolerance and compatibility of the risk/reward profile of the product with the target market.” **We suggest that the wording “risk/reward profile of the product” is deleted under the heading “risk tolerance” and the wording “risk/reward expectations of the client” is referred to under “client objectives” instead.**

4. The distinction between “clients’ objectives” and “clients’ needs” should be better explained. The text suggests that ‘objectives’ refers to the ‘wider financial goals of target clients’, whereas ‘needs’ refers to other goals (such as ethical investment, green investment’). However, this distinction is far from clear and not consistent throughout the text. For example: the inclusion of ‘currency protection’ under “clients’ needs’, clearly refers to financial goals. The example on p 38 refers to “six years’ investment horizon” under “clients’ needs”, whereas Annex III, page 23, includes investment horizon under clients’ objectives. **We suggest to clearly describe what is the difference between clients’ objectives and clients’ needs and to ensure consistency with those definitions in the examples.**
5. With regard to the ‘type of clients to whom the product is targeted’, the SMSG notes that the more refined the description, the greater the risk that concepts are only properly understood in the home market of the manufacturer and interpreted differently cross-border. Also, concepts such as “defensive” / “conservative” / “aggressive” / “speculative” to describe a type of clients may be understood differently between manufacturers and distributors. Hence, the SMSG reiterates that there is a need to define clearly the concepts that are being used. The SMSG would also suggest not to mix categories. For example: why is “sophisticated clients” mentioned among “type of clients”, whereas it refers to elements that are captured under “knowledge and experience”

**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.**

6. It is not clear from the description what the respective responsibilities are in case of instruments that are generally traded on secondary market. For example: who is the manufacturer in case of shares? And how long does the responsibility to define the target market last (suggestion: only at time of introduction)? Who is to be considered as the ‘distributor’ (what with actors who merely act as intermediaries: see in this respect also points 10-11)? And what are the distributor’s responsibilities in case of non-EU instruments (example: IBM shares). The SMSG would like to have more clarity with regard to instruments traded on the secondary market, with possible differentiation among the type of instruments (ranging from shares, bonds... to ETF’s). **The SMSG considers that it would be very helpful if the guidelines provided clear guidance on the responsibilities and treatment of such instruments.**
7. **The SMSG also suggests to include in Annex IV an illustrative example of “shares” and “UCITS” as these are the products most widely sold to retail investors.**

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

8. The respective responsibilities of manufacturer and distributor are feasible within a small market where “everyone knows one another”. However, there is a concern that it could be much more difficult in a large market with a large number of market participants to communicate with each other. For example: “19.... a manufacturer should determine the extent of clients’ information available to the distributor”. How far-going is this meant to be? What is the depth of this requirement? How much is to be done? **We would suggest that ESMA adds examples to show what this means and how this can be done in a pragmatic way.**
9. “20. ... if the product is deemed appropriate for a sale without advice, the firm should also specify the preferred acquisition channel (face-to-face, via telephone, online etc.) and, if relevant, specific design features of the acquisition channel”. This guideline is extremely far-reaching with regard to the responsibility of the manufacturer. Here, the manufacturer is put in a role where he is almost required to micromanage the distribution process. This is even more difficult as the techniques and technology are constantly changing. **We would suggest that it is the responsibility of the distributor to determine the appropriate acquisition channel, within the target market definition given by the manufacturer.**
10. The draft guidelines require distributors to “36.... pay particular attention to situations where they might not be able to conduct a thorough market assessment”: (i) execution services under appropriateness and (ii) execution-only. A footnote is added stating that “even firms providing investment services under appropriateness or execution-only regime, could be in the position to conduct a more thorough assessment of the target market.” In this respect, the SMSG voices several concerns. In particular, it draws the attention on the position of brokers. They act on “execution-only” basis and have under level 1 legislation no obligation to collect information on their clients. It would not be workable, and counter to level 1 legislation, that they are forced by these guidelines, to adhere to the obligations for distributors provided for by these guidelines.
11. There is also a concern that the guidelines could act as a barrier for companies, in particular SME’s, to raise capital on the public markets. In this case, this would run counter to the Commission’s intention to support SME funding via all channels and particular public equity markets. **We suggest that ESMA rephrases its guidelines to ensure that execution-only and execution under appropriateness remain workable.**
12. In defining the distributors’ responsibilities in the specific context where “execution-only” or execution under appropriateness” is possible, **a guiding principle could be that the target market guidelines should not have more restrictive consequences than the “know your client” requirements.** In a context of “execution-only” this would mean that the absence of “know your client” requirements takes precedence over the target market requirements. In the context of “appropriateness”, this would mean the appropriateness test passed by the client, is deemed to be a sufficient condition regarding knowledge and experience to allow the sale of the product, without the distributor being required to verify the other target market criteria described by the manufacturer.

**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.**

13. The members of the SMSG share the concern that a portfolio approach should remain possible because of the benefits it provides to the investor in terms of risk diversification. However, at the same time they share the concern that the degrees of freedom provided to enable this portfolio diversification should not be abused to facilitate miss-selling. **The issue of selling and advising outside the target market requires balancing these considerations.**

14. At the same time, the SMSG reiterates that these guidelines should not be seen in a void but within the wider context of MiFiD II, where, for the distributor, the need to make suitable assessments exist. In this context, the SMSG insists on adequate supervision and supervisory convergence. Guidelines on target market are not a substitute for inadequate supervision; nor can they compensate for weaknesses in suitability assessments.
15. The problem of selling outside the target market relates to the question how broad the product manufacturer should define the target market and which approach he should take in doing so (“single product approach” or “portfolio approach”). In a single product approach, the manufacturer defines the target market as if that product would be the only one to be sold to the client. The target market for single shares would then e.g. be professional clients and speculative retail clients. Under this approach, the wording that selling outside the target market “should not occur on a regular basis” is problematic, since it would not allow a portfolio approach (which implies that a limited percentage of single shares may be suitable for defensive clients to diversify the portfolio). In a “portfolio approach” the manufacturer defines the product as if it was only a part of a portfolio of a client. Under this approach, the issue of selling outside the target market would largely evaporate as most products could probably be described as part of a portfolio. This then raises other issues, such as: is there not a risk that the degrees of freedom allowed to the distributor facilitate miss-selling? Should this portfolio approach also be extended to ‘negative target market’ products? Below, these issues are discussed in more detail. Irrespective of the eventual choice made, **the SMSG proposes that the final ESMA Guidelines:**
  - a. **are clear on the choice made between the two positions (should the product manufacturer delineate the target market from a ‘single product’ or a ‘portfolio’ approach?);**
  - b. **ensure that the guidelines on the extent to which selling outside the target market should be possible correlate to this position.**
16. Different variations to the extreme positions are possible. For example: if the manufacturer is to describe products from a *single product approach*, a generic exception could be provided to the distributor in case of a portfolio approach (in other words: selling outside the target market is allowed as part of a portfolio approach). This could be conditioned in a variety of ways:
  - a. By not extending it to ‘negative target market’ products: in other words, despite the portfolio approach, sales outside the target market would still not be allowed on a regular basis within a negative target market.
  - b. By requiring the distributor to communicate the assumptions of his portfolio approach to the manufacturer. This is needed because to facilitate the latter’s product governance requirements of assessing whether the distributor is fit to distribute his products.
  - c. By requiring that the distributor informs the client of his portfolio approach and the implications for the sales of different categories of products, including the conditions under which, the reasons why and the applicable limits for sales of products that would otherwise be considered outside the target market.
  - d. By requiring that the distributor gives, as part of the feedback loop to the manufacturer, some kind of numerical overview (ex post) of the proportion of sales outside target market, with reasons why.
17. If on the other hand, the manufacturer describes the product from a *portfolio approach*, different approaches can also be imagined.

- a. Here too, a variation could be that the portfolio approach would not extend to “negative target markets”.
- b. In another variation, the product manufacturer would distinguish different target markets depending on the distribution hypotheses (e.g. single shares: first target market consists of professional clients and speculative retail clients; second target market consists of also “defensive clients” for portfolio diversification purposes).
- c. Here too, the distributor could be required, as part of the feedback loop to the manufacturer, to give some kind of numerical indication of sales outside target market.

All these variations have in common that they limit to more or lesser extent the degrees of freedom available to the distributor, and do so in order to prevent miss-selling.

18. While these variations all have a portfolio approach in common, they differ in the underlying assumption: where is the prime responsibility for the portfolio approach assigned: to the distributor or to the manufacturer? An important feature that they have in common is that they assign the responsibility to define a negative target market unequivocally to the manufacturer and leave little room to deviate from that to the distributor.
19. Apart from this, the eventual choice is not indifferent from an operational point of view. The more target markets the manufacturer distinguishes or the higher the level of detail, the higher will be operational requirements if the distributor is required to insert this into his ICT systems.
20. **The SMSG asks ESMA to take this analysis and these concerns into account when finalizing its guidelines.**
21. The SMSG reiterates that the position taken should not affect the possibility of sales in the context of “execution-only” or “execution under appropriateness”.

**Q5: Do you believe further guidance is needed on how distribution should apply product governance requirements for products manufactured by entities falling outside the scope of MiFID II?**

22. These product governance guidelines rest on the assumption that the manufacturer knows best the product characteristics and that the distributors know best the client. Hence, interaction between the two can be helpful to reduce the risk of miss-selling. However, there is an important gap in the interaction, resulting not so much from the guidelines as well as from level 1 legislation. Actually, many asset managers (both UCITS and AIF) are outside the scope of MiFID II. The target market description required from manufacturers is a MiFID II requirement. Hence, asset managers outside the scope of MiFID II are under no legal obligation to define the target market in terms of these guidelines. This means that the responsibility to do so shifts to the distributor (see pt. 39, p 12 of the draft guidelines). As such, it erodes the reasoning behind these guidelines, namely that the interaction of two parties, manufacturer and distributor, the former being knowledgeable of the product, the latter of the investor, is a safeguard to prevent miss-selling. **The SMSG suggests to solve this in a possible update of level 1 legislation (UCITS, AIFMD).**
23. While it would be good to solve this problem in a possible update of level 1 legislation, it is not realistic to assume that this will be done within the timespan available for the implementation of these guidelines. For this reason, **the SMSG suggests that ESMA looks at possible mitigating approaches.**

- a. One such mitigating approach could be to encourage manufacturers outside the scope of MiFID II to define the target market as a service to the distributor: “Where manufacturers outside the scope of MiFID II define target markets as a service to their distributors, they should do so according to these guidelines. Under these circumstances and assuming concertation with their National Competent Authority, distributors could consider their responsibilities to be similar to a situation where the target market was described by a manufacturer inside the scope of MiFID II.”
- b. Another mitigating approach could be to utilize the provision for the PRIIPs-KID to define the target market. “Where a target market has not been described in terms of these guidelines, because the manufacturer is not in the scope of MiFID II, the distributor shall assume his responsibilities to define the target market within the confines of the target market as described on the PRIIPs-KID.” This would imply that the target market description on the KID is a broad summary of the target market, as described under MiFID II product governance requirements (see also point 31 of this advice).

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

24. The SMSG would also like to raise the issue of monitoring and supervision. Who will monitor compliance with these guidelines and how? How is non-compliance being sanctioned and by whom? Assuming that supervision will be done by the National Competent Authority, clarity is needed on how this will be done. Methods can range from e.g. review of governance procedures, use of broad aggregated data to data-querying. However, the latter would require huge cross-border ICT platforms to be set up, especially with regard to the communication between distributor and manufacturer (see also Q9). **Clarity on the requirements stemming from monitoring and supervision is needed.**
25. The SMSG would also like to comment on the knowledge and experience category. While the SMSG is aware of the MiFID II suitability requirements, it is wary that the requirement for the manufacturer to define **knowledge and experience criteria should not result in an inflation of knowledge and experience requirements, that disregard the beneficial role that an investment advisor could play.** The relationship with MiFID II know-your-customer requirements should be clarified.
26. **Clarity is needed that the guidelines do not apply to services as such,** more in particular investment services. The MiFID II, level 1 text relates the target market determination to “financial instruments”. However, the level 2 text (Art 10.1 MiFID II Delegated Directive) and the draft Guidelines by referring to the level 2 text (see point 10, page 5), refer to services. This reference to “services” should, in our view, only be understood as a reference to the obligation of the distributor to take into account which investment services it should provide as part of its distribution strategy. It cannot mean that the distributor should determine a separate target market for the investment services *per se*.
27. A recurring concern is how far the network of communication between distributor and communication should go? Several of the requirements, as already pointed out above, are quite prescriptive and risk to micromanage the distributor’s side. Apart from the concern already mentioned above (is that feasible in a large market or does it reflect too much the reality of a small market where everyone knows one another), **the exchange of information should remain within the constraints of client confidentiality and competition law.**
28. Notwithstanding these focused remarks, the general view of the SMSG on these guidelines is positive. The guidelines provide a sound framework for determining the target market without being overly complicated and as such will contribute to prevent miss-selling.

**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 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, where relevant.**

29. As far as implementation costs are concerned, a critical issue is how the obligations regarding communication between distributor and manufacturer are defined. **If these obligations require that common ICT platforms are to be established, they would require quite heavy ICT resources.**
30. There will be training costs, in particular for sales and advice staff. However, this training will not be disproportionate, as the proposed criteria do not seem to be overly complicated (the draft probability-weighted performance scenarios under PRIIPs are much more difficult to understand and explain properly). Moreover, there is an obligation anyway on financial companies to provide training in light of the MiFID II knowledge criteria. One warning though: there is a risk of a peak load coming together as MiFID II approaches implementation. **For this reason, it would be good that the final guidelines are in place as soon as possible.**
31. The PRIIPs-KID also needs to specify the 'target market'. However, the format of the PRIIPs-KID is standardized and does not allow sufficient space to describe the target market in the same degree of granularity as the guidelines resulting from MiFID II product governance require. Nevertheless, it would be logical to assume that both are aligned. **To remove all possible misunderstandings, we would suggest that the ESMA guidelines are more explicit on the alignment of (i) product governance target market definition and (ii) requirements to indicate target market on publicly available information, in particular PRIIPs-KID, taking into account the need of compactness of the PRIIPs KID.**

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA's website.

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