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EBF response to the ESMA consultation paper on Draft Guidelines on MiFID 2 product governance requirements

General points:

The EBF welcomes a flexible and proportionate approach to the target market assessment which allows for adjustments to the nature of the product and investment services provided.

Coherence/coordination with suitability assessment:

The Guidelines acknowledge that product governance and suitability assessments serve different purposes. However in the EBF view, the Guidelines[1] underestimate the impact that the target market definition has on the suitability assessments. In practice, the granularity of the categories to be considered will require firms to fundamentally review their client classification and not all categories that need to be considered for the purpose of target market identification are captured by the client classification that firms use for MiFID purposes (suitability/appropriateness).

As a matter of fact, distributors not only need to establish procedures to gather all the information on their clients necessary to properly assess the actual target market, but also have to monitor the adherence to the target market on a case-by-case basis when interacting with their clients. It would therefore be useful to clarify the necessary coherence and coordination between product governance rules and the suitability assessment.

Moreover, the different roles and responsibilities of manufacturers and distributors require further distinction. For example, the role of manufacturers should not be expanded to include defining in detail the distribution channels to be used; this responsibility should fall to the distributor given its more appropriate expertise. Whilst we support ESMA's efforts to ensure further alignment between manufacturers and distributors, they do have

[1] ESMA consultation paper: Draft guidelines on MiFID II product governance requirements, October 2016, [Link], hereinafter the "Guidelines".

different roles and expertise, and achieving the increased client protection that ESMA desires will be best delivered by recognising these differences.

Secondary market transactions:

The EBF takes the view that further clarification is needed regarding the application of the product governance rules to secondary market transactions e.g. shares and bonds traded on a trading venue. We note that the term "manufacturer" under MiFID II includes "investment firms that create, develop, issue and/or design financial instruments, including when advising corporate issuers on the launch of new financial instruments" (Recital 15 of MiFID II Delegated Directive).

However, to our understanding, this does not mean that investment firms providing services in relation to an IPO in shares should be considered manufacturers for all subsequent secondary market trading. Instead, the corporate issuer should be considered as the non-MiFID manufacturer and the investment firm transmitting a client's order for execution on venue should be responsible for identifying the target market.

Hence, in accordance with ESMA's Guidelines and the principle of proportionality, the investment firm should then be able to use a simplified approach for identifying target market, e.g. based on the fact that the instruments are non-complex and intended for the mass-market. There should be no need to enter into a separate agreement with corporate issuer or to report back information regarding sales etc.

As a matter of fact, in the absence of a distribution agreement, many of the obligations provided by the MiFID II Delegated Directive in relation to product governance could not be effectively applied and some adaptations/simplifications are needed regarding the definition of the target market (See Q3 and Q5).

Target market categories and assessment:

The set of categories to be used in defining the target market need to be simplified as follows:
i) "Clients' Objectives" should be solely linked to the investment horizon and not also to other items such as liquidity supply or retirement provision, as the time horizon together with the risk profile are the main factors applied to identify the financial characteristics of an investment product;
ii) "Clients' Needs" should be merged with Client Objectives. This is difficult, if not arbitrary, to identify clients' needs differently from the financial characteristics of an investment product.

Furthermore, it should be clearly stated in the Guidelines that for non-advised services relating to simpler and more common products (see paragraph 17 of the Guidelines) the target market could be formed by all the firm investment services clients (i.e. the clients of all the abstract groups on which the firm's client base is divided, for the purpose of the guidelines).

Deviations from the target market that result from proper portfolio diversification objectives should not be seen as an exception but as a key element for investor protection. In this sense, target market identification should not only consider the product when individually assessed but also when part of a broader investment portfolio. There is a need to recognise that the priority is to ensure that clients have an appropriate portfolio of products that spreads according to their preferences in the risk/reward profile, and consequently even a volatile instrument may find its place in a defensive portfolio. An overly restrictive approach in the definition of the target market can prevent the creation of portfolios with an appropriate risk balance. The aim of initial target market to prevent mis-selling, and not with portfolio building in mind.

Moreover, it is unclear in which situations a firm is considered to "recommend and actively market" a financial instrument (Paragraph 43 of the draft Guidelines, page 29), as opposed to providing execution-only services (Paragraph 41 of the draft Guidelines, page 29). We note that according to the draft Guidelines, such a distinction will have a significant impact on the scope of the obligations of the investment firm e.g. whether to conduct a "more thorough assessment of the target market assessment". In our opinion, a firm that only provides clients with the possibility to purchase and sell financial instruments in a pure execution only mode does not mean that the firm "recommends and actively markets" these instruments.

Overall, we fear that by imposing too stringent criteria in the target market definition at the manufacturer level would imply in the long run that many products will no longer be available to clients, contradicting the CMU objectives of jobs and growth. However if manufacturers impose restrictive criteria to the distributors these in turn will prevent products being offered to investors that do not exactly fit their profile. As a consequence, the risk-balance at investor level may tilt towards low risk products not because of the investor benefit, but because intermediaries want to limit legal liabilities.

Target market for investment services:

The EBF notes that the rules on product governance in MiFID II apply to financial instruments and structured deposits. However, at Level 2 (Article 10(1) MiFID II Delegated Directive) and also in the CP (paragraph 10 page 5), it appears as if the obligations for distributors have been extended to "services". The EBF questions if such a requirement to identify target market for investment services is in line with Level 1, and require further clarity as to what "services" actually means in practice.

Exchange of information and data protection issues:

The EBF is concerned how the requirements regarding client information interact with rules on data protection. It is currently unclear whether such requirements on Level 3 such "legal obligations" that would allow firms to compile and process such information without being in breach of data protection rules. We also note that information sharing between manufacturers and distributors in some cases could be sensitive from a bank privacy and competition law perspective. This will be a particularly significant issue when dealing with non-MiFID and/or third country institutions.

The EBF would welcome more illustrative examples in Annex 4 of simple and common products such as UCITS.

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.

In general, we consider these criteria to be more suited to define a client suitability test or build a portfolio than to assess a given product.

According to MiFID II, the requirements on product governance should apply without prejudice to the MiFID II regulation on assessment of suitability and appropriateness (recital 71 MiFID II). MiFID II clearly states that Member States shall allow investment firms to provide certain services to their clients without performing a suitability or appropriateness test (execution only) with a predefined range of "non-complex" products such as shares admitted to trading on a regulated market. In fact, according to paragraph 22 on page 24 of the ESMA CP "the manufacturer should propose the type of investment services through which the targeted clients should or could acquire the financial instrument. If the product is deemed appropriate for sale without advice…". Based on the Level 1 access to execution only-services for non-complex products this assess-ment by the manufacturer would be uncalled for. Narrowing down the execution only scope should be a decision for the distributor to make in line with their knowledge of the client.

In our opinion, the framework suggested by ESMA confers on the manufacturer some attributions that do not correspond to it, such as specifying the preferable acquisition channel or designing a specific channel for the sale of the product. As distributors are professional entities that maintain different distribution and communication channels with their customers, it is up to them to determine if a channel is suitable or not, depending on whether that channel allows compliance with the rules of conduct. This should therefore fall within the scope of the distributor's decision.

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 points which are as far as possible measurable and standardised. The EBF therefore generally welcomes the idea of a minimum list of defined categories which the manufacturer should apply when identifying the target market for a new product (or product type).

We appreciate that ESMA recognises the need for a flexible approach as the manufacturer does not necessarily have direct contact with clients and therefore only undertakes an abstract target market identification (paragraph 12, page 6 of the CP). Thus, although a manufacturer in its internal product governance process will need to go through all six categories (i.e. the categories are cumulative), the principle of proportionality allows it to take into account the nature of the financial instrument and have a more high level approach for products which are non-complex (e.g. UCITS or listed shares) or for types of products which share the same characteristics (e.g. structured products with capital protection). See also reply to Q 2.

The set of categories to be used in defining the target market need to be simplified as follows:
i) "Clients' Objectives" should be solely linked to the investment horizon and not also to other items like liquidity supply or retirement provision, as the time horizon is the main factor – together with the risk profile – to identify the financial characteristics of an investment product;
ii) "Clients' Needs" should be merged into Client Objectives as it is difficult if not arbitrary to identify clients' needs differently from the financial characteristics of an investment product.

If other categories are to be included, several additional aspects need to be taken into consideration.

Regarding "Risk tolerance and compatibility with the product risk profile", the draft Guidelines require firms to use the risk indicator stipulated by the PRIIPs Regulationto fulfill this requirement. However, we do not see any legal basis which obliges firms to use this indicator for this purpose. For example, ESMA should allow firms to also use the UCITS risk indicator where applicable and not only the PRIIPs risk indicator as it is currently stated.

As regards the "knowledge and experience" category, the EBF would welcome further guidelines on how to handle clients which have no previous experience or knowledge of the financial markets at all. Since it must be possible for a client to "start" investing at a certain point in time, it should be possible to include in the target market that a product is compatible for clients with no previous experience and knowledge at all (e.g. for the most simple mass products such as some types of UCITS). A similar clarification is also warranted for first time investors in more complex products.

The EBF finds it difficult to distinguish between the categories "client objectives" and "client needs". We note that the category "client needs" will be applicable in a limited number of situations and should therefore not be a mandatory criteria. For instance, a product that is a "green investment" could typically targeted for investors with ESG-profile but this does not exclude that the product could also be compatible for a client without this specific need. We believe that it should be merged into the "client objective" category. Furthermore clients' objectives" should be solely linked to the investment horizon and not also to other items like liquidity supply or retirement provision, as the time horizon is the main factor – together with the risk profile - to identify the financial characteristics of an investment product. Additionally, cultural and social differences between countries make it difficult to take in consideration such detailed client needs in the definition of the target market. For instance, the need for a "green investment" or "ethical investment" might not have the same significance for all the distributors.

Furthermore, the EBF notes that the provision of the categories Clients' Objectives and Risk Tolerance does not appear consistent with the approach adopted under Article 54 of the Delegated Regulation of 25 April 2016 for the purposes of the assessment of suitability, considering risk tolerance as a sub-category of the customer's investment objectives and not a category of its own. In our opinion it is necessary to ensure coherence between the market targeting criteria adopted by the distributor and those underlying its suitability assessment, as it allows for interpreting in an integrated manner the product governance and suitability assessment rules.

With regards "to the type of clients to whom the product is targeted", ESMA should refrain from opening the door for additional descriptions than the ones provided for under MiFID II; i.e. retail, professional and eligible. Descriptions such as "sophisticated client" could have different meaning in different Member States and could make investors comparisons of products as well as cross border distribution more difficult.

In the case of the category "ability to bear loss" ESMA should introduce a fixed set of information points along the following:

a. The investor seeking full capital protection
b. The investor is seeking partial capital protection and can bear losses to a level specified by the product structure
c. The investor can bear losses up to the invested amount
d. The investor can bear losses beyond the investment amount

The general and basic risk attitudes are more commonly used by distributors and do not fit well in a manufacturer's processes. By adding this to the manufacturer space the scope of deviating interpretations would increase dramatically.

The boundaries between categories must be clearer. For example, there is a clear inconsistency between the categories to be considered as set out in the ESMA consultation paper and the categories that are used in the examples presented in the Annex.

The guidelines state "Clients' Objectives: The firm should specify the investment objectives of target clients, that is the wider financial goals of target clients or the overall strategy they follow when investing. For example, reference could be made to the expected investment horizon (for example, number of years the investment is to be held)". However, in examples 1 and 2, the reference to a "six-year term investment horizon" is considered in the category "Client needs" (when it should be in category "Clients objectives"). The expected time horizon should also be standardized in a scale (v.g. less than one year; between 1 and 3 years; etc.)

Regarding the category "client needs", we do not agree with case study 1 related to the application of the guidelines. In this case study, "client needs" include the "expectation that, at expiry, none of the stocks will be worth less that 50% of the initial valuation". This belongs to the description of the product. The manufacturer should not be so specific in the definition of the target market.

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 generally welcome ESMA's statements regarding the need for a flexible approach as the manufacturer usually does not have direct contact with clients and therefore only can do an abstract target market identification (paragraph 12 page 6 of the CP). Thus, although a manufacturer in its internal product governance process will need to go through all six criteria (i.e. the criteria is cumulative), the principle of proportionality allows it to take into account the nature of the financial instrument and e.g. have a more high level approach for products which are non-complex (for example UCITS or listed shares). In our opinion, there is no additional value to investor protection when applying all six categories in the case of a simple product. An example of a simple product could help determine the target market assessment in these kind of products.

Furthermore, there is no reason to distinguish the "innovative nature" (paragraph 18 draft guidelines) of the product from the complexity of the product. As an innovative product can be both complex or non-complex, and the innovative nature does not add anything to the other categories that firms should consider when defining the target market. There should only be a requirement to distinguish between complex and non-complex products.

The EBF also supports the two examples provided in paragraph 18 of the Consultation Paper (page 7). According to the examples it would be possible to identify the target market categories on the basis of a common approach for all financial instruments of one type if such products are sufficiently comparable e.g. due to an external benchmark. We fully support the need for product governance requirements especially for complex products and where misselling has historically shown to be a problem. However, when it comes to non-complex products the requirements laid down in the guidelines would imply substantial administrative burdens and consequently endanger the open architecture we know today through on-line services.

It should be clearly stated in the guidelines that for non-advised services relating to simpler and more common products (see paragraph 17 of the guidelines) that the target market couldbe formed by all the firm's investment services clients (i.e. the clients of all the abstract groups on which the firms client base is divided, for the purpose of the guidelines).

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

<u>Secondary market transactions:</u>

As mentioned in the General Comments, the EBF believes that further guidance is needed in the Guidelines in respect of the application of the rules on product governance to secondary market transactions e.g. shares and bonds traded on a trading venue.

Our primary interpretation is that for such secondary market trading it is the corporate issuer i.e. a non-MiFID firm which is the manufacturer and that all obligations to assign a target market therefore lies on the distributor. In accordance with ESMA's Guidelines and the principle of proportionality, the investment firm distributing such product should be able to use a simplified approach.

Moreover, this approach requires some additional clarifications in the Guidelines, such as:

i) specification (in the second bullet point of paragraph 52, "information gathering process") that the reasonable step of "entering into an agreement" does not apply in respect of all those products traded on the secondary market (e.g. shares or bonds traded on a venue), i.e. there should be no obligation for distributor to enter into agreements with every corporate issuer

ii) delete paragraph 54 since this measure is excessive and disproportionate to the ultimate purpose of the product governance, and considering also that the lack of information does not depend on the distributor;

iii) specify that in such situations it is not expected to have any information flow from the distributor to the manufacturer, since the latter has no formal obligation to do the review of the product.

As a matter of fact, in case of absence of a distribution agreement many of the obligations provided by MiFID II Delegated Directive in relation to product governance could not be effectively applied. We point out that, in such a case:

- The investment firm/distributor would have no instruments or channels for informing manufacturer about information on sales of the product and, in particular, of sales outside the identified target market, as it would be required by Article 10(9) of the Delegated Directive;
- The manufacturer would not be in a position, with respect to distributor, to fulfil requirements provided by Article 9(15)(f)&(g) of the Delegated Directive, regarding the obligation, upon occurrence of certain events affecting the product, of (i) contacting the distributor in order to discuss a modification of the distribution process or (ii) terminating the relationship with the distributor.

Therefore, we believe that in case of absence of a distribution agreement the following adaptations must be admitted to allow the investment firm to comply with the obligations provided for distributors:

- Defining the target market at distributor level not for each individual product, but for types of products taking into consideration the essential features common to the products themselves (knowledge/experience needed to assess that kind of product, degree of risk, likelihood of creating losses, etc.). The prospect of identifying in this case a target market by product "type" is even more appropriate considering that, however deeply granular the target market is, it would still not allow the maintenance of a truly differentiated target market by each individual product from a particular category;
- Relying on information and assessments, also of risk, made directly by the distributor itself applying as much as possible (and not being obligatory) and on the basis of various service models, the 6 categories provided for in paragraph 16 of the Draft Guidelines. The

speed with which it is necessary to execute the orders received by the investor does not, in fact, allow to collect/review the information made available by the manufacturer. In addition, the information made public by the manufacturer in the documentation relating to the individual product (e.g. KIID or prospectus) and related to the target market are descriptive and thus cannot be managed through information flow made available in a standardized way by the information providers.

The guidelines are incorrectly drafted on the assumption that the distributor has a relationship (usually following a mandate to distribute) with a manufacturer. However, this is not the case for many of the products available on a secondary market. In the situation where a distributor is undertaking secondary market trading in such products where that distributor has no prior relationship with the manufacturer (either directly with the manufacturer or through a chain of distribution agreements), then the expectation that distributors should obtain information from the manufacturer, or else provide feedback to it, is disproportionate given the lack of relationship between the two entities and the lack of market infrastructure to manage the flow of information.

For example, if a vanilla debt product is listed in both Frankfurt and Hong Kong, and the original lead manager is located in London (which should be caught under the current MiFID II definition of manufacturer), it is unclear how such a manufacturer would be able to obtain information from execution brokers outside of the EU, or how brokers both inside and outside the EU could provide the manufacturer the information requested under the guidelines (considering their potential lack of relationship with the manufacturer or even potential general awareness that the lead manager is the manufacturer).

<u>Target market categories and assessment:</u>

The EBF agrees with the general approach that the distributor could generally use the same target market categories as manufacturers and that the target market can be developed taking into account its client base. However, we seek confirmation on that distributors should not solely rely on quantitative criteria but sufficiently balance them with qualitative considerations. This is mentioned in paragraph 13 of the draft Guidelines (page 22) for manufacturers, and we would assume that in order to enable a balanced approach the same would apply to distributors.

We also seek confirmation that distributors – when distributing instruments through non-advised sales (execution-only and sales based on an appropriateness test) should not take into consideration all of the categories in the manufacturers target market. We agree that the level of detail with which the distributor can identify target market will vary depending on the investment services in question.

As a matter of fact distributors have not only to set procedures to gather all the necessary information on their clients to properly assess the actual target market, but they also have to monitor the respect of the target market case-by-case in the concrete interaction with their clients. It would therefore be useful to expressly clarify the necessary coherence/coordination that must be ensured between product governance rules and the suitability assessment.

If clients' access to a wide range of products - and not just in-house products with close connections to the distributor – should be maintained it is important to focus on the principle of proportionality. Consequently it is important to allow for distributors to define target market as mass retail e.g. "shares listed on a regulated market" and not limit the access to execution only services on-line.

According to paragraph 21 on page 24 of the CP "the manufacturer needs to take reasonable steps to ensure that the financial product is distributed to the identified target market." This phrase is unclear. The manufacturer and distributor may be competitors and therefore may not want to disclose all information to each other. ESMA should clarify what is meant by taking reasonable steps.

The EBF notes the statement in paragraph 22 of the draft Guidelines (and paragraph 19 of the Consultation Paper) that the manufacturer should determine the "extent of clients' information available to the distributor". In our opinion, it would not be proportionate to require the manufacturer to make an in-depth analysis of the client information that is available to a third party distributor. Therefore, the EBF urges ESMA to clarify in the final report that only a high level assessment is required, based on publicly available information.

Taking into account the principle of proportionality, it should not be required of distributors to make a thorough target market assessment of products which can be deemed compatible with a mass retail target market (paragraph 41 in the draft Guidelines).

The EBF does not agree with the approach that the manufacturer should go into details about the "preferred acquisition channel". This would create a grey area in terms of the division of responsibilities between manufacturers and distributors. As the distributor is the party with the knowledge of the end-clients it would seem natural and proportional that it is the distributor who makes the call on both investment services and acquisition channel. Thus, the EBF proposes to delete paragraph 22 from the Guidelines. If this is not possible, we propose to replace the word "should" with "may" in the last sentence.

Furthermore, the requirement to report deviations from the target market to the manufacturer should only apply to reoccurring or systematic deviations. The ability of a distributor to provide the manufacturer with information on deviations will depend on the investment services provided. The requirement does not seem well-adapted to the situation where execution only services are provided or when advice is given on the basis of a portfolio approach. How is an investment firm to know whether a client falls within the target market or not? The same problem occurs where a client refuses to provide information on knowledge and experience and decides to invest anyway (i.e. despite warning).

We believe that the statement in paragraph 28 on page 26 "gathered through investment or ancillary services or through other sources," should be regarded with the anti-money laundering rules and its profiling ban. This is a subject that should be clarified because not all other kinds of information can be used.

The EBF finds the wording of paragraph 29 in the draft Guidelines unclear. To our understanding the purpose of this text is not to introduce new requirements per se but to clarify that a firm will not fulfil the product governance rules simply by applying the rules on suitability and appropriateness. Please confirm that this interpretation is correct.

The obligation for distributors to conduct a thorough analysis of the characteristics of its client base, including " any information and data deemed reasonably useful and available for this purpose that may be at the distributors' disposal and gathered through sources other than the provision of investment or ancillary services…" (paragraph 33 page 27) does not respect new rules imposed by the General Data Protection Regulation (2016/679) and leaves members no room for any kind of standardization of their target market processes. Moreover, this obligation could intervene with rules and barriers that banks have in place regarding conflicts of interest. We therefore propose to delete this paragraph from the draft guidelines.

ESMA should clarify what is meant by "regarded as good practice" in paragraph 35 on page 27 of the CP, as in some cases the distributor has more detailed knowledge of the characteristics of the target market which can deviate from the manufacturers target market and broaden it.

The product governance and target market rules should be applied and defined at an early stage before the actual offer of a product to a client, but should otherwise not have an impact on the suitability/appropriateness test. The current draft guidelines however oblige distributors to assess certain aspects of the Target Market on transaction level, i.e. at the moment of the suitability assessment and appropriateness test, e.g. Paragraph 61: "reasons for the deviation should be clearly documented and, where provided, included in the suitability report". This implies that on top of the usual elements that need to be assessed as part of the suitability test (financial situation, objectives, etc.) firms will also need to assess all of the other categories (for instance, clients needs). If not, firms are not able to confirm in the suitability report whether or not there is a deviation from the target market, nor to register whether or not products are offered outside the target market. This is adding an extra layer into the suitability process. It would be useful to expressly clarify the necessary coherence/coordination between product governance rules and the suitability assessment.

The Guidelines should better develop the implications of the fact that the distributor:

1. Defines the target market at an early stage, on an ex-ante basis and before going into daily business (when they define their product assortment) and does so at a general level; this is in order to reduce from the outset any potential risks of failure to comply with the investor protection rules (such as the suitability test);
2. Subsequently applies at the "point of sale" the rules for suitability and appropriateness at single operation level and single client level.

Therefore the target market assessment carried out previously by the distributor at an early stage is then declined at the subsequent level (that is, when the orders relating to individual transactions on financial instruments are given) by the measures and rules relating to the suitability/appropriateness assessment. Consequently, at the "point of sale" the current measures in terms of rules of conduct are deemed valid, even for the purposes of product governance, and the introduction of additional disclosure requirements towards investors such as those set out in points 42 and 61 of the Draft Guidelines do not justify the difficulty of assessment of the target market or deviations from the positive target market defined 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.

No we do not agree with the suggested approach. Considering that proper portfolio diversification is key to any client, independently of its characteristics or objectives, regulatory changes should promote it instead of inhibiting it. Diversification is a result of combining different risks, meaning that products with different characteristics and, a priori, with different target markets may be suitable when assessed within a portfolio approach.

Therefore, deviations from the target market that result from a proper portfolio diversification should not be taken as exceptional but fundamental for investor protection.

In the long run there will be a convergence of the product to the stated profile. For example, a defensive client will have only defensive products which will translate into a skewed portfolio that will over-expose risk management. This is not for the client benefit but because intermediaries will fear legal liabilities by proposing products with a higher risk profile.

Paragraph 30 of the background to the draft Guidelines, makes clear that the target market assessment, as provided by the manufacturer, is essentially focused on the individual product manufactured. It therefore cannot take into account the personal features of each potential client and, in particular, the general situation of his personal investment portfolio. Subsequently, the same paragraph explains that personal features of each client can in any case be properly considered and assessed by the distributor providing its investment services to the client, for example in the context of the suitability (or appropriateness) test. This could in some cases lead to permissible deviations between the general target market of a product (as identified by the manufacturer) and the eligibility of that product for a certain client, provided that the recommendation by the distributor complies with all other applicable legal requirements, especially in terms of suitability also as an instrument for the management of conflict of interests.

This situation does not properly take into account more recent and sophisticated developments in the operating model implemented by investment firms for the provision to clients of investment services, in particular investment advice. Many firms, in fact, are currently offering to their clients (non-independent) investment advice according to a portfolio approach, in which any recommendation issued takes into account not only the personal characteristics of the client (in terms of knowledge and experience in investments, financial situation, investment objectives, risk profile) but also the general situation of its investment portfolio, in terms of underlying financial risks, degree of diversification and financial efficiency. Therefore, the guidelines shall make clear that target market does not apply to those financial instruments invested through portfolio management.

The Guidelines should grant more flexibility with respect to the target market identified by the manufacturer, provided, of course, that all other applicable legal requirements are fulfilled. Provision of investment advice pursuant to the operating model described above – jointly with all other applicable legal requirements – would represent an effective instrument for investment firms for managing their possible conflicts of interest as distributors, also enhancing the degree of protection granted to clients through the implementation of systems for suitability assessment preventing clients from carrying out any transactions which have been considered as unsuitable for them (so called "blocking suitability"). The Guidelines therefore should take the above into account, by deleting or clarifying the ban imposed to distributors with regard to deviations from the target market in situations where a conflict of interests exists.

The EBF appreciates that ESMA has acknowledged that hedging, portfolio diversification and client specific features can lead to permissible deviations from the positive target market. However, while there is a discussion about these aspects in the preamble, we note that the topic is not mentioned in the proposed Guidelines. Since it is a vital part of distributors' operations, we would welcome references to hedging, portfolio diversification and client specific features in the actual Guidelines.

We do not agree with ESMA's thinking that sales outside of the target market should not occur on a regular basis (paragraph 61 of the draft Guidelines). Since the target market is focused on individual products and their characteristics and since investment advisors are focused on providing investment advice based on a client's portfolio of assets and instruments, there is bound to be a discrepancy between these two regimes or processes. This is irrespective of whether the advisor makes use of a range of pre-defined portfolios or customising more individualised portfolios together with the client. Fundamentally, the suitability assessment is the safeguard for bridging the two regimes and enabling a focus on individual features of the client. It is too simplistic to think that a low risk client should only have low risk products and that a high risk client should more or less only have high risk products. Diversification is key, and should be an integral part of an investor's portfolio.

However, to require that sales outside the positive target market should be the "individual case of the client" and documented in the suitability report would preclude investment firms from offering portfolio management services such as predefined portfolios to smaller investors since the individual products within such a portfolio do not consider and handle the individual investor once the investor has been assigned to a suitable predefined portfolio.

The obligation to inform the manufacturer of a deviation from its Target Market should be limited to situations where products are frequently sold outside the target so that there is manifestly a wrong/ill-defined target Market by the Manufacturer (not for individual, nonrepeating cases). Reporting every recurrent deviation (paragraph 65) from the TM is not useful and not foreseen in level 1 texts.

Also, stating that sales outside of the target market should only be a limited occurrence opens the door for different supervisory approaches across Europe as it is a highly subjective criterion. The focus should rather be on ensuring proper documentation of why a diversification has been made, and consequently why a sale outside of the positive target market has occurred. In the opinion of the EBF not only the the suitability report but also other type of documentation can be used for this purpose.

The EBF agrees with ESMA that there are situations where the same type of product could be used to meet different client's objectives or needs and therefore that it should be possible for the firm to identify from the beginning more than one target market of end-users (paragraph 34 page 11 of the CP). This is of particular importance for products with a risk profile that vary depending on the portfolio and investment horizon of the client.

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?

As mentioned under General Comments and Q 3, EBF's interpretation is that for secondary market trading it is the corporate issuer i.e. a non-MiFID firm which is the manufacturer and that all obligations to assign a target market therefore lies on the distributor.

An alternative approach that an investment firm, in order to be classified as a "distributor" in relation to a financial product, shall be somehow connected to the manufacturer of the product and integrated within the distribution chain it has set up for that product (a situation which does not necessarily and automatically occur, in particular when investment firms operate within the secondary market). In such cases "only", the product governance obligations provided by the draft Guidelines in relation to distributors apply.

Differently, investment firms granting their clients, through provision of the service of reception and transmission of orders, with the access to financial products which are issued by third parties (with no contractual relationships with the firms for the distribution of the product) and traded on the secondary market (normally on a trading venue) cannot be classified as "distributors" for the application of product governance rules provided by the Guidelines.

UCITS Management Companies and AIFMs that do not offer any MiFID services are so-called non-MiFID manufacturers. This means that the MiFID distributor has to define its own target market before distributing such products and that the distributor should conduct the necessary information gathering process to form an adequate information basis to fulfil this obligation. This creates a big administrative burden and could lead to distributors limiting their product offer to avoid these obligations that would not be beneficial for clients.

In the EBF's opinion, both as regards secondary market transactions (manufacturer is corporate issuer) and other non-MiFID manufacturers (manufacturer is UCITS/AIF managers), it is necessary to allow for a more flexible application of the rules on product governance by distributors than the "standard" system where the products are issued by MiFID manufacturers.

In particular the Guidelines should:

- explicitly clarify (in the first bullet point of paragraph 52, "target market definition") that the distributor must determine the target market according to the categories mentioned in paragraph 16. However it should be permissible in the absence of any specific information regarding the various categories provided for by the guidelines (not public or not formalized through specific bilateral agreements with issuers being non-MiFID firms in terms of product governance), to define a target market not based on all the categories provided, but only on some of them, or based on information and assessments, including risk assessments, made directly by the distributor;

- specify (in the second bullet point of paragraph 52, "information gathering process") that the reasonable step of "entering into an agreement" does not apply in respect of all those products that are executed by the distributor on the secondary market (e.g. listed shares or bonds e.g. it should not be necessary to enter into agreements with all corporate issuers.

- delete paragraph 54 because this measure is considered excessive and disproportionate to the ultimate purpose of the product governance, and considering also that the lack of information does not depend on the distributor;

- specify that in such situations it is not expected to have any return flow from the distributor to the manufacturer, since the latter has no formal obligation to do the review of the product.

The text of the Guidelines should clarify that the interaction existing within the target market, such as between the product governance process and target market should be present in the KID, even if they aren't directly comparable because the objectives and beneficiaries of the information are different.

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

The EBF supports that investment firms, when appropriate, should identify a negative target market as ESMA notes in paragraph 58 in the guidelines. It is however important that such an identification only needs to be done when such a negative target market is relevant. In cases where a product is not deemed incompatible with a specific group of client, e.g. mass-market retail products, there can be no need to identify a negative target market. The negative target market should not be identified by simply taking the opposing characteristics but rather be an effort to identify those groups of clients the needs, objectives and characteristics of which the product is specifically incompatible.

For instance, as mentioned previously in this response diversification is essential in order to provide adequate investor protection to clients. This means that a product where the investment objective speculation has been identified could very well be compatible for clients with low risk objectives if provided with a portfolio view to the clients' investment. Instead the negative target market should as described above be identified as a specific group of clients for which the product is incompatible if such a group exists. A too-wide definition of the negative target market could have the unwanted effect of limiting investor protection as distributors are restricted from providing their clients with the product best suited for the clients' situation.

ESMA's thinking is that the target market process will lead to the identification of the positive target market, the negative target market and the area between the positive and negative target market. As discussed in our comments to Q4 the focus should be on the possibilities to sell products in the area between the positive target market and the negative target market due to diversification and the way that investment advisory processes are carried out. In this context, and due to the process of diversification, it is important to keep in mind that a distributor may occasionally be in a situation where it would make sense to include in the client's portfolio a minor holding in a product that, seen in isolation, would be within the negative target market. On the occasion of a sale within the negative target market, the distributor should of course document it and include it in the information to be provided to the manufacturer.

The EBF questions the value of requiring manufacturers and distributors to always assign a negative target market for the financial instruments. For online services, it will also be very difficult to keep track if a firm is outside or within the negative target market. Moreover, we wonder how firms are to define a negative target market for products which are aimed for the "mass retail market".

The approach should be taken into account more proportionately: i.e. the distributor should only be obliged to identify a negative target market where this is necessary to stress that certain products are not fit for certain specific types of investors (e.g. very complex products i.e. CoCo's).

We find the phrase on (61) on page 33 "to occur not on a regular basis" too strict because in practice there will be situations where the product is sold outside the positive target market. In a case of portfolio management, this should be allowed to happen and "not on a regular basis" does not fit in that scenario. Also if a client wants to purchase a certain product without investment advice (execution-only), the distributor should be able to sell it to them - if so, this should be clarified. Moreover, in order to avoid legal concerns regarding liability, it should be clarified that a distributor can advise a client to invest in a certain product even if that client is outside the assigned target market, provided that the product is suitable (i.e. following a suitability test).

We consider that the identification of the negative target market should apply the same criteria in terms of standardization of categories, descriptions and classifications by type of product among manufacturers, in order to have a level playing field in the distribution of investment products.

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

In our opinion the Guidelines should not apply to professional clients and eligible counterparties. Alternatively, an investment by a professional client or an eligible counterparty should always be deemed to be within the target market. First, according to the MIFID II directive a professional client "is a client who possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs". Consequently, such a client has the necessary capability to understand and evaluate all six categories of the target market. Second, a professional client is either an institutional investor (such as financial institutions operating under specific permits, e.g. investment firms, credit institutions and insurance companies), large corporate who meet certain quantitative criteria set out in the MIFID II directive or national or supranational authorities such as central banks, offices managing national debts, ECB, EMF, the World bank, etc). The idea that an investment firm needs to protect these clients from making the investment decisions they deem necessary to meet their business needs or their public or governmental requirements seems to be ill conceived. Third, it cannot be in line with the intention and purpose of the MIFID II directive to hinder professional clients such as financial institutions to operate within their specific business authorizations, large corporates who operate within the confines of their commercial activities or national or supranational authorities to conduct their public duties. This reasoning applies even more so for clients classified as eligible counterparties.

These arguments apply equally to clients who have requested to be treated as professional clients given the very high qualitative and quantitative requirements set to be eligible for treatment as a professional client. This conclusion is even more apparent given the fact that i) the client must specifically state in which product or service he wishes to be classified as professional, (ii) the investment firm must give clear warning of the protection and investor compensation rights he may lose, and (iii) the client must state in a separate document that he is aware of the consequence of losing such protection.

According to MiFID II Level 2, when providing an investment service, an investment firm can assume that a professional client has the necessary knowledge and experience for which the client is in order to understand the risks involved in the transaction or in the management of his portfolio (Article 54 (3) and Article 56 (1) of the delegated regulation MiFID II). In paragraph 72 of the Guidelines, ESMA writes about a distinction made in MiFID in assumed knowledge and experience between per se and elective professional clients. The EBF notes that such distinction is made in regard to the classification of clients. So in regards to certain customers an investment firm cannot presume knowledge and experience but should instead conduct an assessment of the clients' expertise, experience and knowledge. However when conducting both the appropriateness test and the knowledge and experience portion of the suitability test an investment firm can assume that a professional client has the necessary knowledge and experience for which the client is classified as a professional client. Since such assumptions are allowed whilst conducting appropriateness or suitability tests the EBF questions the value of any such distinctions when identifying a target market. An investment firm should instead be allowed to assume that a professional client, in regards to the target market, has the necessary knowledge and experience in relation to the products for which the client is classified as professional.

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

MiFID II product governance obligations are to be observed from the date of application of MiFID II (03 January 2018). After 03 January 2018, the distribution of products manufactured before that date should be treated in the same manner as the distribution of products that have been manufactured by entities not subject to the MiFID II product governance requirements, meaning that the distributor has to define the target market for such products before the manufacturer. However, afterwards the manufacturer has to assign a target market to such products following the product review process that has to be conducted according to Article 16(3) of MiFID II. It is not clear what will apply in a situation where the manufacturer following such review would decide on a target market and/or propose distribution channels that significantly differ from the one applied by the distributor (e.g. a negative target market that excludes the group of clients to which the distributor has sold the product).This may prove troublesome when there are several distributors that have previously defined different target markets. The process will be inverted (moving from several targets markets to a single producer target market).

It is also unclear whether the case studies in Annex 4 are examples of manufacturer target markets or distributor target markets. Furthermore, ESMA should add examples for simple products such as UCITS and listed shares in Annex 4. Also examples of negative target market and an example of secondary markets would be helpful.

Information sharing between distributors and manufacturers and the periodical review process are still issues where further guidance would be welcomed (Paragraphs 47 – 50 in the draft Guidelines, page 30). This concerns for example the notion of the interpretation of the "proportionate basis" which manufacturers should use when collecting information for their review, whether inactive products should form part of the review process etc.

The EBF notes that the rules on product governance in MiFID II apply to financial instruments and structured deposits. However, on level 2 (Article 10(1) MiFID II delegated directive) and also in the draft Guidelines, it appears as if the obligations for distributors have been extended to investment services i.e. not only products (paragraph 10 page 5 of the CP). The EBF questions if this interpretation is in line with the level 1 text. In our opinion, the reference to "services" in the delegated directive should only be understood as a reference to the obligation of the distributor to take into account which investment services it should provide as a part of its distribution strategy. It should not create a separate obligation for the distributor to assign target markets for its investment services per se, as paragraph 10 page 5 of the CP seems to suggest. Moreover, in EBF's opinion, the considerations when identifying a target market based on the proposed six categories would be quite different for investment services compared to investment products. In case ESMA takes the view that a distributor should also identify a target market for its investment services, it is therefore important to include clear examples in the Guidelines. To avoid legal uncertainty, the term "services" should also be replaced by "investment services" throughout the document.

Proportionality is a key theme which should be described in more detail in various parts of the guidelines. There is a great risk of having disproportionate actions when assessing the target market if the proportionality is not fully taken into consideration. The proportionality principle should for example enable firms to assign one target market for instruments of the same type and with similar key characteristics e.g. listed shares or structured products with capital protection. In addition, for simple products such as listed shares or UCITS funds which are open to the public it should be possible to take a high level approach e.g. set a target market that includes all types of clients with a certain investment horizon (according to the UCITS KIID).

In relation to product governance rules and the target market required by investment firms we would like the ESMA Guidelines to take into account the peculiarities of portfolio management investment service. In our view this investment service cannot be considered as a form of distribution of financial instruments as portfolio management aims at investing the client assets in accordance to the contractual mandate given by the client relating to the specific objectives of the portfolio management and its investment rules. Consequently the portfolio manager does not market or offer financial instruments, but rather fulfils a complex investment service by purchasing and selling financial instruments in the name and behalf of the client through its mandate. It is therefore consistent with the specific nature of this investment service to conceive the product governance obligation at the portfolio level rather than then for the financial instruments to be purchased through the portfolio manager.

In relation to the above, we believe that itis necessary to reconsider the ESMA's proposal in paragraph 43 of draft guidelines where it is said that "if distributors intend to approach clients or potential clients in any way, to recommended or actively market a product or consider that product for the provision of portfolio management, it is expected that a thorough assessment of the target market is always conducted". Furthermore, it is important to foresee that in the case of investment portfolio management, the firm that provides the service should apply the manufacturer product governance provisions to the portfolio management. The application of the rules as a manufacturer seems to be borne out also by ESMA's Final Report – Technical Advice to the Commission on MiFID II (ESMA 2014/1569, pag. 52).

The guidelines require that there should be a regular review to assess whether products and services are actually reaching the target market. It needs to be clarified in the draft Guidelines how the review obligation interacts with the obligation to identify a target market and the principle of proportionality. In particular it should be stated that where a distributor has made a more restricted target market assessment and only taken a limited number of categories into account, the review process should have the same scope. For example, if a firm distributes instruments based on appropriateness test and only has access to information on clients' knowledge and experience it is this category which the distributor should evaluate in its regular review (i.e. not the other criteria which the distributor may not have any information on due to the choice of distribution channel). On the other hand, if the firm provides investment advice and has made a more thorough target market identification, the regular review should normally encompass all categories.

The guidelines should also consider the case for co-manufacturing, which is currently not included. With regard to the identification of the target market by the distributor, we think that the guidelines do not sufficiently consider the case 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 07/04/2016 and also in EIOPA's consultation on product governance requirements under IDD. According to the definition provided in Art. 9, "manufacturing", can include both the activities of "issuance" and "design". However, it is common practice in the market that such activities are performed by different market participants who co-manufacture the product.

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.

In our opinion, the definition of a target market for each product as proposed (based on manufacturers' judgment and lacking standardized criteria and descriptions), would translate into significant costs that would severely impact the Capital Markets Union's objectives. The Target Market requirements create a lot of (one-off and ongoing) costs on ICT level such as: implementation of these guidelines on distribution level, training of sales staff, adapting procedures to inform manufacturers of any deviation of TM, enhancement of suitability tests, draft TM for products manufactured by entities not subject to MIFID II, impact on K&E questionnaire, risk profiles, online monitoring platforms, etc.

About EBF

The European Banking Federation is the voice of the European banking sector, uniting 32 national banking associations in Europe that together represent some 4,500 banks - large and small, wholesale and retail, local and international - employing about 2.5 million people. EBF members represent banks that make available loans to the European economy in excess of €20 trillion and that securely handle more than 300 million payment transactions per day. Launched in 1960, the EBF is committed to creating a single market for financial services in the European Union and to supporting policies that foster economic growth.

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