Manufacturer and Distributor Industry Target Market Working Group –
Response to ESMA Consultation Paper on the Draft guidelines on MiFID II product governance requirements

Who we are

A number of initiatives have been undertaken by various product provider industry associations, including the UK's Investment Association and Tax Incentivised Savings Association, the European Fund & Asset Management Association, and the British Bankers Association. This Group was formed informally with the aim of reaching a consensus on those aspects of product governance which impact firms through the distribution chain, with a focus on the funds industry, using the EFAMA target market model as the starting point. The members of the Group can be found below:

<u>Asset Managers</u>

Aberdeen
Amundi
BlackRock
BNP Paribas
Credit Suisse
Fidelity
Henderson
Invesco
M&G
MFS
Morgan Stanley
Pictet Asset Management
Santander Asset Management
Vanguard

<u>Distributors</u>

Allfunds
Credit Suisse Fund Lab
Deutsche Bank
Fund Channel
FundsNetwork
Intesa Sanpaolo
Santander
UBS Fondcenter

<u>Links into MiFID II workstreams of:</u>

EFAMA
TISA
Investment Association

Executive summary

The Group supports the broad thrust of the product governance draft guidelines, but does believe that the intermediated nature of fund distribution, while facilitating healthy competition between products, renders target market definition communication and oversight much more complex.

In particular the Group makes the following four points:

1. Greater standardisation of target market is a pre-requisite to achieving the investor protection aims

The Group supports the broad approach presented in the CP and agrees with the six target market categories proposed. However, the Group is of the view that the definition of target market must be standardised to a much greater degree, into clear, unambiguous categories to facilitate scalable electronic communication and a common understanding across the industry

In order for the industry to develop a scalable reporting solution it is the Group's view that further guidance from ESMA on the scope of application and on the feedback information to be provided is required – the Group proposes that such oversight should not be required for UCITS and retail AIFs, which are highly regulated in their own right and designed specifically for the mass retail market.

Where applicable, the Group proposes that such feedback information should be limited to client type and distribution channel. This aligns with the recommendation regarding the approach to Distributor Target Market definition below.

2. The approach for distributors should be differentiated to take account of the service they offer

The Group is of the view that a distributor's product selection process should only take account of the client type, the distribution channel and the general level of knowledge & experience of the customers for each channel considered. The Group recommends that this is clarified and linked to the target market framework in paragraphs 23-29 of the draft guidance.

The Group is of the view that as the suitability assessment already takes into account an investor's needs, objectives, attitude to loss, risk tolerance and individual circumstances, distributors should not be required to further define target market in these terms on an individual product basis, as there is no additional benefit to the investor.

3. Clarification on the role of investor understanding on target market is required

The Group is of the opinion that when taking a product's features into account when determining a target market, manufacturers and distributors should also consider the likely ability of the target market to understand the potential investment outcome and the risks to achieving that outcome, rather than solely making an assessment on the likely understanding of the underlying investment strategy.

4. A definition of distribution by MiFID service is required.

In particular the Group is of the view that the MiFID service of portfolio management does not constitute distribution.

These points are explored in more detail below.

Introductory Comments

The Group welcomes the Consultation Paper (the "CP") and supports ESMA objectives to enhance the protection of investors and ensure that end investor best interests are considered throughout the distribution chain.

The Group has observed that the vast majority of funds available to retail investors across Europe are "plain vanilla" funds designed for mass market consumption (e.g. UCITS, and retail AIFs) by investors with little or no previous knowledge or experience. Furthermore, the funds industry is already regulated to a high standard through the UCITS and AIFM directives, and has suffered few of the challenges of other investment product categories, as evidenced by the generally very low level of product complaints across the industry. The Group therefore welcomes the opportunity a apply proportionality recognised in the CP.

Investment products are distributed in three main ways in Europe – (i) vertically integrated distribution; (ii) open architecture; and (iii) secondary market for listed products, such as shares, ETFs and Investment Trusts.

It is the view of the Group that the intermediated nature of fund distribution facilitates healthy competition between products but renders target market definition communication and oversight much more complex.

Further, the regulatory requirement for distributors to justify the client benefit of any inducements they receive reduces inherent conflicts of interest and improves investor protection, whilst maintaining easy access to investment products.

Indeed the Group would expect intermediation to be increased by the inducements requirements as, under the Delegated Acts, two of the three examples cited require non-independent distributors to include third party products if continuing to receive inducements (see para 2 of Article 11 of the Delegated Acts dated 7.4.2016).

The Group, however, is strongly of the view that as drafted, there is a possibility that the intermediated model of distribution, which the Group believes serves investors well, may become less attractive. In addition, the Group considers that the current form of the draft guidance may compel some distributors to behave in a way which is not in the best interests of their investors.

The Group believes that the minor changes suggested in this response will avert this, whilst supporting the thrust of the regulation to improve investor protection across Europe.

The Group would like to highlight a number of specific concerns as set out below.

Greater standardisation of target market is a pre-requisite to achieving the investor protection aims
The Group supports the broad approach presented in the CP and agrees with the six target market categories proposed. However, the Group is of the view that the definition of target market must be standardised to a much greater degree, into clear, unambiguous categories to facilitate scalable electronic communication and a common understanding across the industry.

The Group proposes a standardised framework for defining manufacturer target market, as set out in Annex 1 of this response.

The proposed framework is product driven, reflecting the separation of most manufacturers from the investor's individual circumstances, sets clear boundaries between the categories, and we believe is sufficiently flexible to adapt to most investment instruments.

Data vendors across Europe already disseminate information between manufacturers and distributors, and are likely to incorporate the target market parameters – a pre-requisite for this, however, will be standardisation of the target market framework.

However, for sales reporting back to manufacturers from distributors, there is no existing infrastructure which can be leveraged, meaning the industry must develop an infrastructure from scratch. The absence of a standardised framework will significantly hamper the industry's delivery, particularly in relation to intermediated distribution, where the number and the complexity of relationships make bilateral feedback impractical.

In order for the industry to develop a scalable reporting solution it is the Group's view that further guidance from ESMA on the scope of application and on the feedback information to be provided is required – the Group proposes that such oversight should not be required for UCITS and retail AIFs, which are highly regulated in their own right and designed specifically for the mass retail market.

Where applicable, the Group proposes that such feedback information should be limited to client type and distribution channel. This aligns with the recommendation regarding the approach to Distributor Target Market definition below.

Potential unintended consequences:
It is the Group's view that, if clearer standardisation of target market is not mandated by regulation, along with a clarification of scope there may be a number of unintended consequences:

- *Reduction in availability of products:* as intermediated distributors reduce their range of products to reduce product governance operational complexity.
- *Reduction in number of manufacturer-distributor/intermediary relationships: as* intermediated distributors reduce the number manufacturer partnerships in order to reduce the operational complexity arising from the MiFID II product governance requirements.
- *Barriers to entry for new intermediated distributors:* intermediated distribution may be seen as a less attractive option for distributors due to product governance operational complexity, and may result in some existing firms deciding to exit the market or reshape their service.
- *Consolidation of manufacturers:* a reduction in the number of distribution relationships as described may drive manufacturer consolidation in favour of large manufacturers and reducing investor choice.

1 Product-Driven approach to Distributor Target Market

The Group is of the view that the CP's approach to target market from a distributor perspective requires further refinement to fully reflect the nature of the distributor's role and decision making.

Specifically, throughout the CP, it is implied that the distributor target market approach is essentially to take a manufacturer's target market and expand **all** six categories in greater detail. This implies that products are always sold individually and in isolation, rather than, as if often the case, in combination, as a portfolio, to meet a specific client need.

A significant example of this "individual product" approach in the CP is that it states that each individual product should exceed the risk appetite of the individual investor only rarely.

This "individual product" approach is appropriate for the small range of products designed to be held as standalone investments. However, this approach does not reflect the best interests of investors who are seeking a diversified portfolio of investments, or how the majority of fund distribution occurs in practice, particularly in the advised open architecture or discretionary portfolio management channels.

The Group supports the requirements set out in paragraphs 23-28, regarding the selection of products to be made available through each distribution channel.

The Group is of the view that a distributor's product selection process should only take account of the client type, the distribution channel and the *general* level of knowledge & experience of the customers for each channel considered. The Group recommends that this is clarified and linked to the target market framework in paragraphs 23-29 of the draft guidance.

This approach aligns with the limited knowledge available to a reception and transmission service firm and the Group welcomes ESMA's recognition of this in paragraph 39 of the draft guidance. The Group notes that Investment Advisory and Portfolio Management firms are already obligated to undertake a suitability test which covers the individual's specific knowledge and experience together with the remaining target market categories.

The Group is of the view that as the suitability assessment already takes into account an investor's needs, objectives, attitude to loss, risk tolerance and individual circumstances, distributors should not be required to further define target market in these terms on an individual product basis, as there is no additional benefit to the investor.

This two stage approach with a high level review (client type, distribution channel, general knowledge and experience) by the distributor of the manufacturer target market, followed by an individual suitability assessment where required, aligns to the majority of the provisions within the CP. Distributors would still be able to construct diversified portfolios for investors to meet client needs, (and which currently appear to be precluded by paragraph 31 of the CP), without restricting the existing service-driven open architecture distribution model, notably in private banking and wealth management services, which the Group believes serves investors well.

Potential unintended consequences:
It is the Group's view that, the product-led approach to distributor target market as defined in the draft guidelines may result in disadvantage to customers in the following ways:

- *Product-led distribution:* framing distributor target market as product-led rather than client-led may require distributors to move to a product-led distribution strategy at the expense of the current service-based approach, which looks at investor needs and investor outcomes holistically; and
- *Poor investor outcomes:* proper diversification (including across the spectrum of risk assets) is key to delivering long term performance whilst reducing the volatility of returns for the investor. If the target market criteria for each individual product held must align fully to an investor's overall criteria, investor outcomes are likely to be restricted from benefiting fully from diversification, including reducing the asset classes available to many investors.

2 Using Investor Understanding to Inform Target Market

Certain investment products may be designed to produce a "simple" outcome for investors but utilise a more "complicated" investment strategy to achieve this outcome. An example might be multi-asset designed to deliver more consistent and less volatile investment returns than single asset class funds.

The Group is of the opinion that when taking a product's features into account when determining a target market, manufacturers and distributors should also consider the likely ability of the target market to understand the potential investment outcome and the risks to achieving that outcome, rather than solely making an assessment on the likely understanding of the underlying investment strategy.

Potential unintended consequences:
It is the Group's view that, without further clarifying this approach in the guidelines there is the risk of the following unintended consequences:

- *Restricted product choice and less certain investor outcomes:* The availability of products which have been specifically designed to meet the needs of mass retail investors may be restricted as the strategy is "complicated", but the outcome is "simple" and easy to understand.

3 Defining Distribution & Portfolio Management

The term "distributor" is undefined in MiFID II, which leads to some confusion regarding scope. The Group asks ESMA to clarify the term "distributor" in terms of MiFID services as outlined in response to question 3.

Whilst investments may be held in the name of the investor, the investor has signed up to a mandate and delegated decision-making to a professional investor. The portfolio manager is obligated to manage within that mandate and to ensure that such a mandate is suitable for the investor.

As outlined in 3 above, a key consideration should be whether or not the investor understands the range of outcomes for their mandate, not of the individual investments, and that the target market for the mandate meets the investor needs, not that of the individual investments. It is the Group's view that when determining the types of products suited to the portfolio of a Portfolio Management client, it is the knowledge & experience of the portfolio manager which should be taken into account, rather than that of the investor.

The Group is of the view that the MiFID service of portfolio management does not constitute distribution.

Potential unintended consequences:
It is the Group's view that, without clarifying these responsibilities there is the risk of the following unintended consequences:

- Distributors may limit the provision of portfolio management services as the regulatory overhead is increased whilst their ability to provide a fully diversified portfolio is constrained.

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.

The Group welcomes the clarifications regarding the six categories that should usually be considered in the target market definitions and broadly agrees with the categories proposed. The Group believes that the examples given in the sections covering financial capacity, objectives and needs are overlapping however, and the Group suggests that further clarification and standardisation is required in order to ensure that all parties in the distribution chain fully understand the target market.

The Group is also of the opinion that when assessing the target market definition all elements must be taken together, rather than focusing on any one category. The combined framework, together with the options, is set out in Annex 1 of this response. Set out below are the Group's comments on the categories, which aligns with the EFAMA framework. The Group is of the view that the definition of target market must be standardised to a much greater degree, into clear, unambiguous categories to facilitate scalable electronic communication and a common understanding across the industry. The Group has the following observations.

<u>Client type</u>

We recommend that the definition of client type should be consistent with the definitions in MiFID II:

- Retail
- Professional
- Eligible Counterparty

The introduction of further descriptions such as private wealth or sophisticated clients is likely to create further complexity and variability that will not improve the definition but will make it harder to communicate. Reference to "sophisticated clients" adds further confusion as it overlaps with and is more relevant to the knowledge and experience category.

<u>Knowledge & Experience</u>

Clarifications:
The Group supports the investor protection objectives of the product governance provisions within MiFID II; however we recommend three clarifications to the requirements as set out in paragraph 16(b) of the draft guidelines:

1) It is not a requirement to have both knowledge and experience in all cases. This is important, as it must be recognised that first time investors will not have experience.
2) It should be recognised that a product's Offering Documents should be sufficient to meet the "basic" knowledge criteria for simpler products, such as non-structured UCITS aimed at mass retail investors. The content of the UCITS KIID (and the PRIIPS KID) have been prescribed by regulation to achieve this objective.
3) The examples outlined in the CP do not quantify experience in terms of time. We propose that the associated reference in the draft guidelines should be removed. This would recognise that from a fund manager's perspective, it is not practical to give a meaningful assessment, given its separation from the end-investor.

What should the investor understand?
In much the same way as a driver does not need to know how the engine in his or her car works in order to know how it will behave on the road, the Group is of the opinion that the focus should be on the understanding of the range of investment outcomes and the risks or circumstances in which these may not be achieved, rather than solely on understanding the investment strategy. or example, a multi asset fund fund may have a more "complicated" strategy involving a number of assets and exposures.

We suggest that ESMA should add the following text for this category '*for a given product, the manufacturer is responsible for evaluating the ability of target investors to understand the range of possible investment outcomes and the risks to those outcomes, taking account product features such as investment strategy and charging structures*'.

The Group's recommended categories:
We recommend that knowledge & experience should be defined as follows:

Product Category	Knowledge	Experience
Retail: Basic	Based on regulated and authorised offering documentation only	None
Retail: Informed	Based on offering docs, but understanding of the specific factors highlighted by the offering docs	None
Retail: Expert	As Retail: Informed	Benefit from previous experience in the investing in such products, or from investment advice

Ability to bear losses

We agree with text outlined in 16 (c) but suggest that manufacturers should identify which of the below descriptions best align to the product:

- The investor seeking to preserve capital or can bear losses to a level specified by the product structure
- The investor can bear losses – i.e. investors can accept the losses from their initial investment in exchange for the potential of higher returns
- The investor can bear losses beyond the investment amount

These categories generally align to the structure of the product. The first category describes products aimed at investors who are seeking certainty in relation to the downside risk (likely to be delivered by cash investments, and structured deposits), and the third category is aimed at investors who are comfortable with speculation (for example, derivatives). The vast majority of investment funds would be categorised as the second category, with the level of potential losses determined by the risk profile of the product, but in any case cannot exceed the initial amount invested.

Clients' Objectives

It would not be practical for manufacturers to set out an exhaustive list of investor objectives that products can be used for, such as retirement, school fees, etc. For example, an equity fund may be used as part of a number of such long terms savings aims. Similarly, a short-term bond fund could be used for income, liquidity or as part of a retirement plan – both in accumulation and drawdown. It is the view of this Group that defining products in such terms is likely to result in all funds appearing to be suited to all purposes and therefore reduce transparency, rather than increase it.

Additionally, not all MiFID services will be in a position to assess the investor's individual objective, other than in the abstract. Only Investment Advice and Portfolio Management, which undertake a suitability assessment, will gather information on the investor's individual objective – Reception & Transmission distributors will not.

To this end, the Group has focused (see the target market framework in Annex 1) on return profile and time horizon as the key elements of client objectives.

Return profile:	**Time Horizon:**
• Preservation • Growth • Income • Other	• Short (e.g. <3 years) • Medium (e.g. > 3 years) • Long (e.g. > 5 years)

We believe the granular information that manufacturers will attribute to Clients' Objectives will also enhance advisers' capability to fulfil their suitability obligation.

Clients' Needs

Similar to client objectives - from a product manufacturer's perspective, the majority of the needs outlined in Annex 1refer to investment style (green, ethical, etc.), rather than a specific investor need. Again in the interests of transparency and comparability, the Group proposes that standard terminology should be used. Further, the Group proposes that clients' needs should be framed in terms of:

1) Usage – whether a product could be used – for example – as a discreet investment solution or a component of a portfolio only; and
2) Access – i.e. withdrawal rights and the circumstances when withdrawals may be restricted.

The Group's proposed categories are set out below:

Usage:	**Access (withdrawals):**
• Solution • Core or Component of a Portfolio • Hedging • Speculation* • Other (e.g. Sharia, Ethical, Tax mgt, etc.)	• Ready access – normal market conditions • Ready access with restrictions • Access uncertain

*This reflects the ESMA reference in paragraph 16(d) but the Group notes that asset management products are typically designed for long term investment and/or liquidity management so will not normally be designed for the purposes of speculation.

This approach aligns to ensuring that manufacturers describe products consistently. Taking "Usage" as an example, categorising in consistent language across the industry would enable manufacturers to use language in the description of products which is consistent, which in turn enables investors (who may be making decisions unaided) to compare products, and provides distributors with sufficient and consistent information to match products or combinations of products, to the specific investment goals of their clients.

Risk tolerance

This category is addressed in more detail in answer to Q4.

Summary comments

In summary, the Group is of the view that it is particularly important for distributor and investor understanding that clarity is maintained in defining criteria. They should be explicit and complimentary and without duplication. In the main text, annex and case studies of the CP, a number of examples are used in different criteria almost interchangeably, e.g. sophisticated as a client type overlaps with experience. The categorisation this Group intends to use can be explicitly defined, are clear and unambiguous, and can be communicated both in text, in the form of clear narrative product descriptions, or in data terms, facilitating electronic communication to distributors throughout the intermediated distribution chain.

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.

The Group agrees with the proposed guidelines. The focus of the examples in the main body of the text however is on defining target market in relation to how a product delivers the investment outcome to which it is suited. It is the view of this Group that investor needs are rarely defined in terms of investment strategy, but are more likely to be aligned to the investment outcome.

Furthermore, the Group notes that in paragraph 17 of the Background section of the CP, complexity of return profile is considered a key determinant in differentiating target market on the basis of the nature of the product. The Group supports this approach. However, paragraph 18 of the draft guidelines does not make this a clarification. The Group suggests that when differentiating target market on the basis of the nature of the product, the focus should be on the complexity of potential investment outcomes, and the complexity of investment strategy is an important but secondary consideration, except where such investment strategy complexity gives rise to the complexity of investment outcomes. We therefore recommend that paragraph 18 of draft guidelines be amended to read as follows:

> *"This means that the target market identification should consider the characteristics of the products including complexity, the risk-reward profile or liquidity or the innovative nature of the product. In determining complexity, consideration should be given to the complexity of the risk-reward profile and the costs and charges structure, and the consequent likelihood that targeted investors will be able to make an informed investment decision about these potential investment outcomes. The complexity of the investment strategy should also be taken into consideration, where it has the potential to increase the complexity of the investment outcome."*

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

Whilst the Group supports the approach of defining target market from the manufacturer's perspective using the six categories, the Group is of the view that the CP's approach to target market from a distributor perspective requires further refinement to fully reflect the nature of the distributor's role and decision making.

Specifically, stipulations in parts of the CP result in a lack of clarity regarding application in practice. Notably paragraph 30 of the background, and paragraphs 29, 30 and 32 of the draft guidelines, all refer to target market being product related, irrespective of the MiFID service through which the investor invests. This implies that each investment transaction must be considered independently of any others when meeting the target market expectations of the draft guidelines.

Investor Protection

It is the Group's experience that the vast majority of investors hold a number of investments, usually purchased together as a portfolio, irrespective of the MiFID service through which they are sold, rather than purchasing as a result of the promotion of a specific product in isolation. The Group is of the view that this service-driven approach to distribution of investment products, which seeks to match a combination of products to address an individual investor's requirements, is better aligned to meeting investor needs and protection.

Framing distributor target market as product-led rather than client-led may require distributors to move to a product-led distribution strategy at the expense of the current service-based approach, which looks at investor needs and investor outcomes holistically. The Group is concerned that this may not be in the best interests of investors.

Distributor Product Selection:
Consequently, it is the Group's view that distributor target market should take account of the nature of both the service and products it offers. As acknowledged in paragraphs 22-24 of the CP, this fully aligns with the product governance expectations set out in Article 10 of the delegated directive.

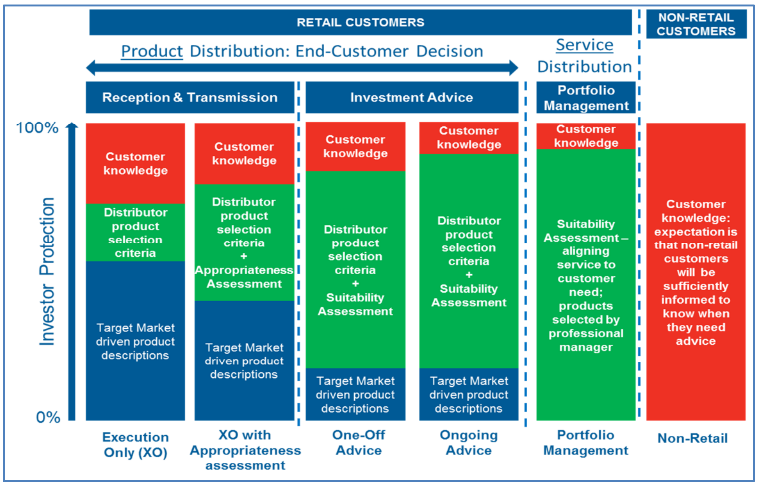
Specifically, the Group proposes that when determining the investment products a distributor chooses to offer its investors, consideration should be given to selecting those products which are aligned to the client type and general knowledge & experience of their client base and to the distribution channel for which it is being selected. In setting the range of products a distributor offers, consideration should be given to the broader categories of target market and the range it needs to meet the wide range of individual needs, objectives, attitudes to loss and risk tolerances of their investor base. This aligns with the distributor product governance requirements set out in paragraphs 23-28 of the draft guidelines.

However, paragraphs 29 and 30 of the draft guidelines imply that distributors must define a target market for each product in terms of all six categories set out for manufacturers in paragraph 16 of the guidance. This suggests that each product will be sold in isolation to investors, and as set out above, and explored in more detail in response to Q4, this is not the case for the vast majority of investment products – it is usual for products to be sold in combination.

Relevance of manufacturer-defined target market to investor protection

Furthermore, the Group supports the view, as set out in paragraph 38 of the draft guidelines that investor protection changes according to the MiFID service through which the product is acquired (see illustration below), and consequently the relevance of manufacturer-defined target market to overall investor protection also changes.

The Group is of the view that the manufacturer's target market is most important in relation to reception & transmission (RTO) services, where the distributor selects products to offer through their service to align with the *general* knowledge and experience of their client base. RTO service providers offer access to these investments but perform a limited role in assessing the investor's need or circumstances. In this situation, the product description, informed by the target market assessment provides the investor protection in conjunction with the RTO distributor's selection process.



Investment Advisors on the other hand are required to undertake a suitability assessment and then make a personal recommendation of a product or combination of products which align to the investor overall needs, objectives, risk tolerance, attitude to loss and specific knowledge and experience. The target market of individual products will be factored into the overall investment recommendation, but does not in itself drive the sale of the product.

Portfolio management

Portfolio management services are distinct from both RTO and Investment Advisory services, in that the investor has purchased the service of managing investment to an agreed mandate. The investor does not make the ultimate decision regarding the purchase of the investments held under the mandate; this is delegated to the professional portfolio manager. In essence, the portfolio manager is a "buyer" of the assets to fulfil the mandate, rather than a "seller" of the underlying funds to the investor.

Further, the Group proposes that, under such an arrangement, it is the investment professional's knowledge and experience together with its detailed knowledge of his / her client's needs and circumstances, which should be taken into account when considering the compatibility of the product, and not that of the end investor. Therefore, investments should not necessarily be restricted to funds aimed at retail investors. It should further be noted that the potential for 'product push' is significantly reduced under MiFID II because of the prohibition on portfolio managers from accepting & retaining monetary inducements.

Finally, the Group requests that ESMA clarifies what constitutes distribution of products in terms of the MiFID defined services, as the term is not defined by regulation currently. It is the Group's view that, both RTO and Investment Advice services are product distribution, as the ultimate decision to purchase the investment is made by the end investor. However, it is the Group's view that Portfolio Management services should not be considered to be product distribution as, from the investor's point of view, the decisions on purchase of specific products is made by the portfolio manager.

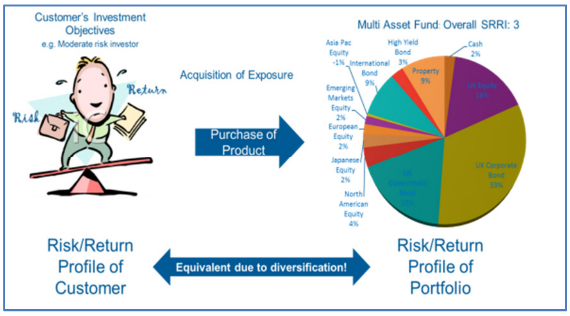
Q4: Do you agree with the suggested approach on hedging and portfolio diversification aspects? If not, please explain what changes should be made and why.

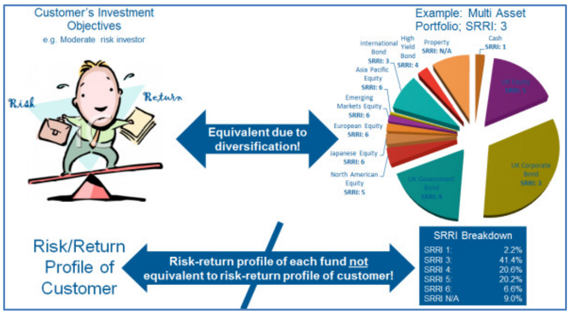
Whilst it is clearly relevant for distributors from a target market perspective it is the Group's view that risk tolerance and compatibility of the risk/reward profile should be interpreted differently for manufacturers.

We would point out that manufacturers do not classify clients into a system of "risk attitude categories" for suitability purposes as stated in Paragraph 13 of the CP. It would be helpful to make clearer that this is a distributor process.

The Group is highly supportive of the argument outlined in paragraph 31, but does not agree, as suggested in paragraph 32, that including a very risky investment in the portfolio of a conservative investor should not occur on a regular basis. The guidelines have to clearly reflect the difference between a risk rating of a particular product and the risk/reward profile of an investor. These are not the same – certainly not when the client holds them as part of a portfolio.

As an example, one of our members has a multi asset product offering that benefits of diversified returns with a low volatility illustrated by an SRRI of 3 (see illustrations below). The product is aimed at investors who would be categorised as "conservative" or "balanced", to use the terminology referred to in Annex 3. However, investment advisors looking to construct an equivalent portfolio from its constituent parts would fall foul of paragraph 31 of the CP, as the riskier assets (which make up more than half the fund) would be deemed incompatible with an investor of this risk profile.





A further concern is behavioural. A number of distributors across Europe have advised that they may take a conservative approach to aligning funds to investors in view of the provisions in paragraph 31. Using the example above, one distributor has confirmed that their working assumption is that for clients with a balanced or conservative profile (i.e. analogous with the multi asset fund with an SRRI of 3) who are seeking to build a portfolio of investments to meet their needs will only be offered products for his portfolio with a maximum SRRI of 3. We believe this is not in the best interests of clients, as it unnecessarily constrains them to investing in multi asset products, which may not be optimal to their needs or in a diversified portfolio of assets as long as they have an SRRI no greater than that aligned to the client – which themselves are likely to result in a concentration in a particular asset class (e.g. bonds) for the lower risk profiled individuals.

Evidence from one of the members of the Group which operates retail platforms in Europe suggests that 95% of advised portfolios in one jurisdiction, and 80% of self-directed portfolios in another, held funds with a wide variety of risk profiles, using the SRRI as the measure of risk.

The Group recognises that the SRRI is a relatively narrow measure of risk and that broader risk concerns should be taken into account when determining the compatibility of a specific product to an individual investor (including factors such as liquidity, the expected use, etc.) and that the product features as a whole should be taken into consideration. That is why, as stated in the introductory comments, we believe that target market definition as a holistic concept describes more than the six parts/categories in isolation. Nevertheless, the above examples demonstrate that it is not a rare occurrence for investors to hold assets with a wide range of risk-return profiles to meet an overall investment objective, but actually occurs in the majority of cases.

More generally, it is the Group's contention that, with the exception of products for which there is the possibility that the investor could lose more than they invested, it is not the risk of a given product which must align to the risk tolerance of the investor, it is the level of exposure, given that risk tolerance. Even investors with a low risk of loss may invest in high risk products, but in smaller amounts relative to their overall portfolio. The Group also noted that customer risk appetite is not assessed under RTO services – such services seek to offer a wide range of products suited to the overall knowledge and experience of their customer-base, but do not have the permissions to undertake analysis of, and provide feedback on, the risk appetite of individual investors.

However, for services which undertake suitability, the Group proposes that the guidance in paragraph 31 of the CP should be amended to reflect that the priority is to ensure that the risk of the overall portfolio recommended to an end-investor aligns to their risk appetite. Additionally, within this context, the Group proposes that the guidance should reflect the expectation that firms should consider whether the risk profile of individual products is compatible with the risk profile of the end-investor, but the expectation that exceptions in alignment will be rare should be removed.

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?

Yes – we believe there is a definite need for further guidance on how distributors deal with non-MiFID II entities, in particular UCITS firms and for those non-MiFID II firms who may be looking to apply MiFID II product governance good practice across all entities e.g. should a distributor decline to provide target market information back to what they consider to be a non-MiFID II firm.

There is a lack of clarity regarding the application of the MiFID requirements to non-MIFID firms (e.g. UCITS Man Cos or AIFMs) as well as the extra-territorial scope (e.g. MIFID manufacturer distributing outside of the EU). National Competent Authorities and distributors within the European Union are interpreting the requirements differently, particularly in relation to the need to provide reporting and/or target market exceptions, resulting an differences in requirements between firms and jurisdictions.

The Group therefore requests that ESMA provides a case study for a non-complex instrument (such as a non-complex UCITS) with further information on the obligations on MiFID firms to provide sales information to non-MiFID firms, and the expectations with respect to the scope, approach and application of sales reporting and target market oversight for non-complex products aimed at mass market distribution.

Finally, ESMA should consider that a lack of harmonisation in the application of the MiFID II product governance requirements (or equivalent) to all manufacturers and distributors of retail investment products in the European Union increases the risk of customer detriment where a MiFID firm is not involved in the distribution chain.

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

Agree - although it is the view of the Group that the proposed approach should be more nuanced than a narrow consideration of compatible or not compatible. Some categories can be more easily defined in the negative e.g. ability to bear losses, and may actually be better understood in the negative than the positive.

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

Yes.

The primary intention of Article 24(2) (Level 1 directive) is to enhance investor protection for retail customers. It is understood that the same level of regulatory protection is not required for professional customers. In addition, products and services aimed at professional investors are in most cases already specifically tailored to their needs and therefore defining a target market would not lead to a better outcome for these clients. Furthermore, Article 24 (1) ("the duty to act honestly, fairly and professionally tin accordance with the best interests of the client….") continues to apply to professional clients.

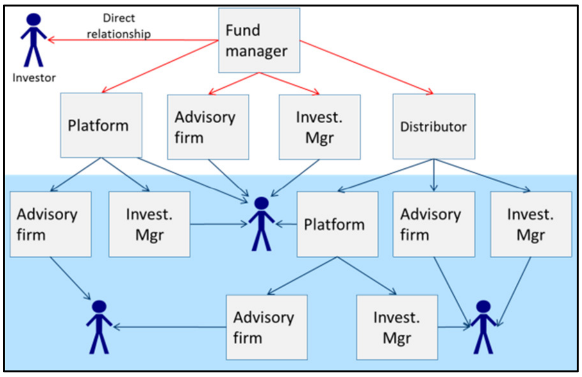
Therefore, in our view, the target market definition and monitoring of sales activities should be focused on retail clients' needs and protection.

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

In addition, the Group has the following suggestions:

Distribution Strategy

The complexity of intermediated distribution (see diagram right) naturally means that manufacturers, such as fund managers, are distant from end investors, and the nature of the distribution chain is such that there is often no legal engagement between the fund manufacturer and the distributor of the product to the end client.



The Group supports the assertion in paragraph 19 that the fund manager should define which distribution channels are compatible with the target market of each product.

However, the distance from the end investor means that manufacturers are not in a position to effectively assess the appropriateness of the means of distributing the product through different distribution channel media, as set out in paragraphs 20 and 21 of the CP; this is best determined by the distributor who has the relationship with the investor.

Further, it is the view of the Group that, where a manufacturer considers that a product sold execution only should not be sold via an online service, it is questionable whether it is advisable to offer the product at all, and therefore the additional breakdown and guidelines are not relevant and further add an additional layer of complexity which reduces the ability of firms to comply.

Communication of target market by product providers

The Group seeks further guidance in relation to the medium for distributing target market information in two areas:

1) Narrative: The Group's preference is not to develop a separate document, but rather to incorporate the narrative into the offering documents for the investment. From a funds perspective, this would be the KIID or PRIIPS KID, subject to the regulatory constraints on space and content for these documents. This approach will enhance investor protection because these documents must be provided to the investor prior to sale - particularly in relation to RTO services, where the distributor plays no part in assessing the compatibility of a given product to the investors' needs. The investor, therefore, is highly reliant on the offering documents in making their investment decisions. Further clarification and standardisation of approach for products that do not have a KIID or PRIIPS KID would be helpful to ensure consistency and a standardisation across the industry.

2) Data: A fully narrative form is useful when considering products in isolation, but in order for distributors to compare and contrast products, greater standardisation is required. The Group recommends that ESMA adopts an approach which enables communication of target market in a standardised data form, such as that set out in the Annex to this letter.

Without a standardised data-driven approach, there is the risk of a reduction in the investment options available to investors, as distributors are unable to reasonably meet their MiFID II product governance obligations, given the complexity of the intermediated model.

Target Market oversight

The CP is silent with respect to target market oversight with the exception of Annex paragraph 48, which refers to distributors not having to supply data to manufacturers on an "instrument by instrument" basis.

ESMA is asked to consider providing further guidance to the industry in the following areas:

- Scope: The Group is of the strong view that:
  - Mass retail products – there is limited benefit of target market oversight in relation to products specifically designed for the mass retail market, and proposes that the oversight requirements should not apply to UCITS and Retail AIFs. Such products are already subject to comprehensive regulations designed to protect the interests of retail investors, and are not in any case subject to MiFID II. ESMA would appear to acknowledge this in clarifying the proportionate treatment of manufacturers of non-MiFID product.
  - The oversight requirements should not apply to listed investments – such as ETF and investment trusts that are listed on secondary capital markets and have the same distribution model as an ordinary share. It would also be difficult for the manufacturer to receive Sales data back due to the anonymous investor base on exchange.
- Approach: There is a lack of clarity regarding regulatory expectations in relation to target market oversight, together with intermediated nature of fund distribution and the absence of a contractual relationship between the end distributor and manufacturer is preventing industry from reaching a consensus. Options considered range from sales breakdown by client type and distribution channel, to exception reporting fitting into existing Know Your Distributor (KYD) requirements.

  The Group is of the strong view that, for those products in scope, a standardised approach to sales reporting is required, but for the industry to develop a solution which can be implemented across Europe and through the intermediated distribution chain will require clarification from ESMA on the approach expected.

  The Group's recommendation is that ESMA mandates that reporting should be, at a minimum, by client type and distribution channel, acknowledging that for products distributed globally there will be jurisdictions outside Europe where such a breakdown will not be available.

Notwithstanding the recommendations of the Group, ESMA is asked to provided clear guidance on each of these points, taking into account the range of MiFID instruments sold by distributors such as banks, the relative simplicity of funds and the absence of existing infrastructure through which such reporting may be facilitated, beyond bilateral arrangements, which are clearly impractical given the scale of intermediation within the industry.

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.

Reference cost benefit analysis (Annex 2)

MiFID 2 will drive revenues down significantly for many distributors (one firm in our group has estimated revenues will drop 25%). Some retail organizations may consider the distribution of investments too risky and complex and withdraw from the investments market, reducing investors' access.

Equally, ongoing operating costs will rise as a result of the increased regulatory engagement between distributors and manufacturers, with large implementation costs in 2017. The costs in 2017 will be heightened further as the requirements remain unclear.

In relation to the product governance requirements, there are two key drivers which will determine the level of cost for the funds industry. These are set out below.

<u>Target Market Oversight:</u>

The expectations in relation to the oversight of target market (see answer to Q8) will be one of the key drivers of cost for the industry as a whole. As outlined above, whilst there is infrastructure to support the communication of the manufacturer's target market to distributors – both through the Offering Documents description, and through data vendors (for funds), there is no existing infrastructure to facilitate sales or target market exceptions reporting.

Consequently, clarification on the approach and scope of the target market oversight requirements will be a material driver of cost for the industry, and quantification is not possible without such clarification.

<u>Distributor Target Market Definition</u>

As highlighted in response to Q3, the Group is of the view that target market for MiFID II services should not be product led. However, if the Group's recommendation to define target market in relation to services is not accepted by ESMA, then the cost of implementation of target market for distributors could be quite significant, as defining target market by product-by-product, with reference to each manufacturer defines target market, will be very onerous.

A further driver of cost in this regard relates to the nature of the target market definition. Without standardisation into a clear, data-driven definition, this task will be essentially impractical for distributors which offer an open architecture approach, and compounded for those distributors, such as the larger banks, which offer a wide range of MiFID II instruments to their customers, not just funds.

The Group proposes that the ESMA considers adopting a clearer data driven approach to target market, along the lines of that outlined in the Annexe 1 to this response.

Annex 1 – Group Target Market Framework

Target Market Framework			Options (for each option, unless stated otherwise)
Client Type	• Retail • Professional • Eligible Counterparty		*Y = Directly in the target market* *N = Clearly outside of the target market (Negative Target Market)* *Blank = Manufacturer wasn't designing the product for this use but accepts it may be compatible*
Knowledge & Experience	• Basic • Informed • Expert		*Y = Directly in the target market* *N = Clearly outside of the target market (Negative Target Market)*
Ability to bear losses	• The investor seeking to preserve capital or can bear losses to a level specified by the product structure • The investor can bear losses • The investor can bear losses beyond the investment amount		*Y = Directly in the target market* *N = Clearly outside of the target market (Negative Target Market)*
Client objectives	**Return profile:** • Preservation • Growth • Income • Other	**Time Horizon:** • Short (e.g. <3 years) • Medium (e.g. > 3 years) • Long (e.g. > 5 years)	*Y = Directly in the target market* *N = Clearly outside of the target market (Negative Target Market)* *Blank = Manufacturer wasn't designing the product for this use but accepts it may be compatible*
Client needs	**Usage:** • Solution • Core or Component of a Portfolio • Hedging • Speculation • Other e.g. Sharia, Ethical, Tax mgt	**Access (withdrawals):** • Ready access – normal market conditions • Ready access with restrictions • Access uncertain	*Y = Directly in the target market* *N = Clearly outside of the target market (Negative Target Market)* *Blank = Manufacturer wasn't designing the product for this use but accepts it may be compatible* *Access – Y for one option only, N for the others.*
Risk	• SRRI (or equivalent) • Key risks of which the investor must be aware		*SRRI is a simple integer 1 – 7* *Key risks*
Distribution Strategy			
Channel	• Execution Only – retail (RTO) • Execution Only with Appropriateness Assessment – retail (RTO) • Investment Advice - retail • Portfolio Management - retail • Non-Retail	Note: Local strategies such as placement (Italy) and marketing/ guided sales (Spain) also remain under discussion	*Y = Directly in the target market* *N = Clearly outside of the target market (Negative Target Market)* *Blank = Manufacturer wasn't designing the product for this use but accepts it may be compatible*