

POSITION PAPER – MiFID II PRODUCT GOVERNANCE

Position Dutch Banking Association (NVB)¹ to the ESMA Consultation Paper ‘Draft guidelines on MiFID II product governance requirements’

Dutch banks are committed to ensure further improvement of investor protection and to restore investor confidence in the financial markets. We fully support the introduction of product governance rules for investment firms, including the ESMA guidelines. The Dutch financial sector has already gained a lot of experience with product governance rules, as we already have statutory financial product governance rules in place for other financial products, apart from investment products, with the same purpose as those rules envisaged by MiFID II.

The existing product governance rules have proven to have a positive effect on consumer protection and confidence in financial institutions. However, it is important to stress that applying those existing product governance rules in the same way and manner to investment products, such as the target market principle, will have a different impact. Applying the target market principle to thousands of investment products per investment firm will have a different impact in comparison to e.g. the target market to ten variations of residential mortgages. In the interest of availability for retail investors to a sufficient broad “universe” of investment products, a proportionate approach of the product governance rules is necessary. Not doing this will lead to less diversified investments portfolios with a higher risk profile, increased costs for retail investors or even investment firms not offering its investment services anymore to mass retail clients, especially with regard to advisory and execution only services. This is especially important, as several governments are currently withdrawing from collective pension schemes. The group of people that are “self-employed” and need to take care of their own pension is growing rapidly. As a result building up private capital in anticipation of these developments will become increasingly important, including and even especially for the mass retail clients.

In this position paper we share our comments on the ESMA Consultation Paper ‘Draft guidelines on MiFID II product governance requirements’, hereinafter the “Consultation Paper”. Our position can also be viewed in the context of the EU Capital Markets Union, as boosting retail investments is an important cornerstone in order to develop the CMU further. We would like to stress the potential impact of product governance on the decreasing liquidity of the markets of financial instruments.

Our points below refer to the Consultation Paper:

- 1. Target market**
 - a. List of categories used for defining the target market
 - b. Distribution strategy not to be determined by the manufacturer
 - c. Diversification of portfolios
- 2. Proportionate approach**
- 3. Execution only**
- 4. Corporate issues**
- 5. Transitional provisions**

¹ The Nederlandse Vereniging van Banken (NVB) is the representative voice of the Dutch banking community with over 80 member firms, large and small, domestic and international, carrying out business in the Dutch market and overseas. The NVB strives towards a strong, healthy and internationally competitive banking industry in the Netherlands, whilst working towards wider single market aims in Europe.

1. Target market

a. List of categories used for defining the target market

Although we believe that the list of categories as proposed by ESMA may be useful for defining the target market by both manufacturer and distributor, the Dutch Banking Association is of the opinion that not all six categories should in all cases have to be used as a minimum basis for the target market assessment. Usage of such categories will depend on the relevant investment product (complex, non-complex), the investment services provided (execution only services or other investment services, see also sub 3 'Execution only regime') and the client classification (non-professional and professional/eligible counterparty).

Not all categories, or the envisaged usage thereof, may be suitable for the manufacturer to define the target market of the investment product. In particular, the category "financial situation with a focus on the ability to bear losses" is a category which should not in detail have to be specified by the manufacturer. This is more up to the distributor. Only in case the investor may incur additional payment obligations that might exceed the amount invested, this should explicitly be part of the target market assessment. Furthermore, the category "client needs" should not always need to be part of the target market. There may be investment products where specific needs and specifications thereof may not be relevant at all.

Furthermore, the Dutch Banking Association is of the opinion that the list of categories that may be used by both manufacturer and distributor should be limited to the categories as mentioned in the Consultation Paper. Where a manufacturer or distributor needs more sophistication for its target market, the listed categories should be sufficient.

More concrete, the Dutch Banking Association proposes that:

1. for non-complex investment products both manufacturer and distributor should be allowed to only use category 'type of client' ("category 1" of the target market). In addition of, the assumption should be that there is no "negative target market".
2. for complex investment products in execution only services both manufacturer and distributor should be allowed to use only category 1, and category 'knowledge and experience' ("category 2"). And in addition – to the extent necessary - also the "negative target" market ("category 7"). If clients fall into the negative target market as defined by the distributor, determining the consequence is the sole discretion of the distributor.
3. for complex investments products in other investment services, in addition, also the category risk tolerance and compatibility of the risk/reward profile ("category 4") should be used.

	Execution only	Other investment services
Complex	1,2,7	1,2,4,7
Non-complex	(1)	(1)

Both manufacturer and distributor may use more of the listed categories, but this should not be mandatory. This principle should apply to all types of investment services.

Definition of target market in a standardized way

The ESMA guidelines product governance should be designed in such way as to allow manufacturers and distributors to carry out a standardized definition of target market on the basis of specific categories (and criteria). ESMA seems to go beyond this and describes the target market in a descriptive and detailed way in the case studies. This approach is problematic because of the large number of investment products and the large number of

market participants active within the internal market. It may become difficult, if not impossible, for investment firms to match the target market criteria defined by manufacturers with the target market criteria defined for their own clients. Furthermore it could hinder cross-border distribution.

b. Distribution strategy not to be determined by the manufacturer

Neither the type of investment service through which the investment product should be distributed nor the type of acquisition channel should be determined by the manufacturer. Defining and assessing the distribution strategy and the appropriate channel should be to the sole discretion of the distributor. The target market as defined by the manufacturer should be sufficient enough for enabling the distributor to assess its distribution strategy. A view to the contrary may have a negative impact on the ability of an investment firm in its role as distributor in the manner in which it may sell investment products via its available investment services and acquisition channels.

c. Diversification of investment portfolios

Deviations from the target market that result from proper portfolio diversification objectives should not be taken as an exception but as a key element of investor protection. In this sense, target market identification should not only consider the financial instrument when individually assessed but also when part of a broader investment portfolio.

2. Proportionate approach

ESMA acknowledges the need of a proportionate approach. A proportionate approach for defining the target market is in particular important for non-complex products and professional and eligible counterparties. Given the large number non-complex products that are traded on stock markets and through other venues which are easy accessible for the public, such as ordinary shares, depositary receipts, corporate bonds, government bonds and UCITS-investment funds, a simple uniform approach to the identification of the target market of such type of products would be appropriate. Professional clients and eligible counterparties are deemed to have the necessary knowledge and experience when they invest.

3. Execution only regime

The ESMA guidelines on product governance requirements should make a clear distinction between target market identification requirements that apply under the execution only regime and under the provision of investment advisory or asset management services regime, since in the latter case, it is possible to conduct a relative more thorough assessment of the target market and obtain information about aspects such as the clients' financial situation and clients' objectives.

4. Corporate issues

The Dutch Banking Association has identified that, under consideration 15 of the MiFID Commission delegated directive of 7 April 2016, investment firms advising corporate issuers on the launch of new financial instruments should be considered as manufacturers. We express various concerns in this respect regarding the role of its members in debt and equity capital markets transactions going forward.

5. Transitional provisions

With regard to the application of product governance requirements to the distribution of products that were issued before the entry into force of MiFID II, we question whether ESMA has the mandate to issue as a guideline (level 3) a so far reaching requirement. The approach followed by ESMA is also contrary to and deviating from the EBA-guidelines on product oversight and governance arrangements for retail banking products (EBA/GL/2015/18). We would recommend that distributors (like manufacturers) can determine the target market for existing investment products at a point in time when the first regular review of the respective products occurs.

Annex

1. Target market and diversification of investment portfolios

According to the Consultation Paper the manufacturer has to define a target market for their products according to a list of categories.² The distributor also has to define a target market, using the same categories as manufacturers but in a more granular way.³ ESMA considers that the target market assessment is product-related and is aimed at a group of target clients. The perspective of the target market is according to ESMA the individual product.⁴

Risk profile of a client diversified portfolio

ESMA's point of view fails to appreciate that distributors, when acting as investment advisor or individual portfolio manager, translate the "suitability" categories (type of client, knowledge and experience, financial situation, risk tolerance, objectives) into a risk profile on a portfolio level. These risk profiles vary from very defensive (low risk) to very offensive (high risk). Each risk profile has its own asset allocation. The products will be divided among asset categories like: equities, fixed income, alternative investments (such as: real estate, hedge funds and commodities) and liquidities, with certain bandwidths per asset category. This diversification over asset classes leads to the best return (in relation to risk). Within each asset category further diversification can be achieved across regions and industries and different investment products.

As a result of diversification low risk portfolio's may contain (limited) investment products with a high(er) risk and – vice versa – high(er) risk portfolio's may contain (limited) products with a low(er) risk. This diversification at portfolio level will lead to deviations at the level of an individual financial instrument as a rule and not as an exception. Although the Consultation Paper seems to acknowledge the practice of diversification⁵ ESMA states that "They should not occur on a regular basis."⁶ These views are incompatible. The draft guidelines in the Consultation Paper will result on a portfolio level to less diversification and a higher risk in relation to return. Another undesired side-effect may be that investors with a lower risk profile that wish to (partially) invest in investment products with higher risk, choose a higher risk profile for their portfolio than in fact would be suitable for them.

Furthermore, the perspective that the target market is the individual product may result in a higher (administrative) burden for distributors. They seem to be required to report deviations to the manufacturer. Or are these deviations deemed "not relevant" for the product governance process of the manufacturer and should therefore not be regarded as deviations that have to be reported?⁷ If not, how does this relate to the generic requirement for the distributor to inform manufacturers on sales.⁸ Will this not result in unnecessary discussions between manufacturers and distributors?

² 11, page 5

³ 26, page 9

⁴ 30, page 10

⁵ See the example given in 31, page 10.

⁶ 32, page 10

⁷ "Deviations from the target market (outside the "positive" or within the "negative") which may be relevant for the product governance process of the manufacturer (especially those which are not individually unique/exceptional) should be reported to the manufacturer." (33, page 10)

⁸ Member States shall ensure distributors provide manufacturers with information on sales and, where appropriate, information on the above reviews to support product reviews carried out by manufacturers. Article 10(9) Delegate Directive 7 April 2016

Furthermore, the (administrative) burden for distributors will rise because distributors are required to document each deviation and include it in the suitability report towards the client.⁹ We question if ESMA has the authority to impose more stringent requirements on the suitability report than the Delegated Regulation¹⁰. In summary the investment firm is only required to explain the investor why a given advice is suitable and not why it is suitable despite another target market description from the manufacturer. Recommending a financial instrument because it fits the client's portfolio and at the same time informing the client that he is outside the target market for that same financial instrument, is likely to result in unnecessary confusion of the client. Besides, we note that ESMA is not authorized to determine additional requirements to suitability reports as a side effect of Level 3 guidelines on MiFID II product governance requirements.

The above mentioned negative results of the perspective of the target market on a product level will increase if the manufacturer describes the target market in a (too) narrow manner. ESMA presumes that the manufacturer will describe the target market in an abstract and – implicitly – in a broader manner than the distributor.¹¹ Distributors are presumed to describe the target market in a more granular way, taking the “potential” target market from the manufacturer and its boundaries as a starting point.¹² Because the Consultation Paper does not prescribe how each category for each product has to be defined¹³ these presumptions are at least uncertain.

Investment horizon of the investment product & investment horizon of the client's portfolio

Furthermore, where a manufacturer has included an expected investment horizon for its individual investment product as part of the client's investment objective category, such investment horizon may not be compatible with the overall investment horizon of the client's overall portfolio. For example, where the investment product indicates a holding period for > 7 year, whereas the client investment horizon has an investment horizon < 7 year for the overall portfolio. In such case, the Consultation Paper implies that such investment products are distributed outside the target market of the investment product, and therefore the distributor seems to be forced to report such deviation to the manufacturer. Or may have to explain to the client why such investment product may still be suitable or appropriate to the client. In such case, similar to the risk profile and diversified portfolio approach, such deviations should not be regarded or be accepted as an exception where part of a diversified portfolio. Moreover, the distributor should be allowed to inform in a more generic manner both the manufacturer and the client of such deviations. Particularly, where such products are being part of a diversified portfolio of the client.

2. Proportionate approach

It is important that for non-complex products the identification of the target market can be done in less detail. A more generic approach to the target market assessment for non-complex products should be allowed because such products would be considered potentially appropriate for any investor. The Consultation Paper recognizes that for non-complex investment products it is likely that the target market will be identified with less detail. It is understood by ESMA that in many cases such products can be compatible with the ‘mass retail market’. But the question is what ‘mass retail market’ means and therefore for what types of products a less detailed approach suffices. It is also not clear to what detail a target market for such type of products need to be defined. Given the large number non-complex products that are traded on stock markets and through other venues which are easy accessible for the public, such as ordinary shares, depositary receipts, corporate bonds,

⁹ “When a product is distributed outside the target market, the reason for the deviation should be clearly documented and included in the suitability report (where applicable).” 32, page 10

¹⁰ The requirements can be found in article 54 (12) DR 25 April 2016.

¹¹ 12, page 6

¹² 26, page 9

¹³ 12, page 6

government bonds and UCITS-investment funds, a simple uniform approach to the identification of the target market of such type of products would be appropriate. We are of the opinion that, when defining the target market, only the type of clients to whom the product is targeted should be used for that purpose. Therefore for non-complex investment products, the manufacturer, but also the distributor in the absence of a manufacturer that falls under the MiFID II product governance regime, should only need to apply category 1 of the categories as identified by ESMA.

A proportionate approach is also relevant in case of the manufacturing and distribution of financial instrument to professional clients and eligible counterparties as end-clients. These clients are deemed to have the necessary knowledge and experience when they invest. To be more specific in our opinion the six categories as described on page 5 and 6 for determining the target market are not suitable to be used with professional clients and eligible counterparties as end-clients. They are also not necessary for the group of non-complex products as these are compatible for the target market “mass retail”. We would like to ask ESMA to amend the draft guidelines of the Consultation Paper in accordance with the foregoing.

3. Execution only services

The guidelines on product governance requirements should make a clear distinction between target market identification requirements that apply under the execution only regime and under the provision of investment advisory services or asset management services regime, since in the latter case, it is possible to conduct a relative more thorough assessment of the target market and obtain information about aspects such as the clients’ financial situation and clients’ objectives. The Dutch Banking Association is of the opinion that in case services are offered under the execution only regime the identification of the target market should be done in an appropriate and proportionate manner meaning that a distributor will only have to assess the compatibility of complex products with the knowledge and experience of its clients and the type of client, but not with its clients’ financial situation, risk tolerance and compatibility of the risk/reward profile, and its clients’ objectives and needs. And when performing execution only services in non-complex products an investment firm should be able to classify all products as mass retail without any further assessment. See for further explanation below.

a. *Execution only services with appropriateness test*

- When offering execution only services under the appropriateness regime, investment firms will not be able to conduct a target market assessment in line with the 6 categories defined by ESMA. When offering services under the appropriateness regime investment firms (both credit institutions and investment firms without this status) will normally be limited to assessment of the categories knowledge and experience. Therefore an assessment on the clients’ financial situation, risk tolerance and compatibility of the risk/reward profile, and the clients’ objectives and needs should not form part of the target market assessment.
- However, even under the execution only regime with appropriateness test an investment firm, where clients or potential clients do not provide (sufficient) information regarding their knowledge and experience, a target market assessment on knowledge and experience will not be possible, nor necessary according to the appropriateness test.
- More concrete, the Dutch Banking Association proposes that for complex investment products in execution only services both manufacturer and distributor should be allowed to use only category 1, and category ‘knowledge and experience’ (“category 2”). And in addition – to the extent necessary - also the “negative target” market (“category “7”). If clients fall into the negative target market as defined by the distributor, determining the consequence is the sole discretion of the distributor.

	Execution only
Complex	1,2,7

b. *Execution only services without appropriateness test*

- When offering execution only services without an appropriateness regime, investment firms acting as distributor will not be able to conduct a target market assessment in line with the proposed 6 categories by ESMA, not even on knowledge and experience.
- Therefore an investment firm should be able to classify all non-complex products as mass retail without any further assessment of the client's knowledge and experience, its financial situation, risk tolerance and compatibility of the risk/reward profile, or its objectives or needs. This would be an appropriate and proportionate approach.
- More concrete, the Dutch Banking Association proposes that for non-complex investment products both manufacturer and distributor should be allowed to only use category 'type of client' ('category 1' of the target market). In addition hereof, the assumption should be that there is no 'negative target market'.

	Execution only
Non-complex	(1)

4. Corporate issues

The Dutch Banking Association has identified that under consideration 15 of the MiFID Commission delegated directive of 7 April 2016 (the "Directive") investment firms advising corporate issuers on the launch of new financial instruments should be considered as manufacturers. This means that for debt and equity capital markets transactions the investment firm providing advice to the corporate issuer on the launch of new debt or equity securities (financial instruments) will be considered the manufacturer and the investment firms underwriting the debt or equity issue of the corporate issuer will be considered distributors.

With respect to the above there are certain scenario's possible in relation to which the Dutch Banking Association would want to raise the following concerns/questions:

- a. We note that in principal we feel that the product governance rules should not apply to the advisors anyway, but to the corporate / issuer of the financial instrument. Compare the Final Report where ESMA states: "Going forward ESMA considers that the EC should consider the possibility to align the relevant UCITS and AIFMD articles with the product governance obligations for manufacturers."¹⁴ If ESMA has no mandate to bind corporates, corporate issuances should be exempted. Moreover, we have difficulty understanding why a new obligation has been created on Level 2 in a recital rather than in the body of the Directive.
- b. Of concern to the Dutch Banking Association is that when looking at the wording of consideration 15 of the Directive, there seems to be a double standard as investment firm(s) advising on the launch of new debt or equity securities of an investment firm they do not become manufacturer as a result of such advice, whereas advice by the same investment firm(s) on the launch of a new debt or equity securities of a corporate will lead to such investment firm(s) becoming manufacturer for that transaction. Besides that

¹⁴ Paragraph 9, page 52 Final Report (16 December 2014, ESMA /2014/1569)

we feel there is a double standard and a lack of consistency here, we remain of the principal position that for the purpose of these transactions it is against current market practice to assume an obligation as manufacturer for these corporate issuers. In general these transaction types are usually not the type of transactions for which aftercare is assumed or standard. Therefore bringing these transactions in scope assumes aftercare responsibilities which might lead to revision of the fee model to take the aftercare into consideration.

- c. We note that in our view advice in the this context does not amount to MiFID II advice. We ask ESMA to clarify when the product governance rules would apply with respect to ECM and DCM transactions. Furthermore consideration 15 seems to be focusing on “new” financial instruments, (i) what is considered to be “new” and (ii) does this mean that an investment firm advising on the launch of debt or equity transactions where the financial instrument is not considered “new” (for example tap issues for the debt capital markets practice and accelerated bookbuild transactions in the equity capital markets or secondary market transactions) is exempt from the manufacturer role?
- d. In debt or equity transactions it is common practice that there are multiple investment firms advising on the launch of the debt or equity securities issue and these are all also involved in the syndicate of banks underwriting (with or without firm commitment) the debt or equity issue of the corporate issuer. Given the potential number of syndicates of investment firms involved in advising the corporate issuer on the launch of the debt or equity issue by that corporate issuer who of these advisers will be considered the manufacturer? Is this a situation which is envisaged to be governed by paragraph 8 of article 9 of the Directive and would require a written agreement between parties?
- e. Realizing the nature of the financial instrument used in these types of transactions the question comes up for how long the manufacturer will be bound to its obligations as manufacturer for these corporate issuers as a result of giving advice on the launch of new financial instruments? We would welcome ESMA to clarify this.
- f. In terms of grandfathering, we presume that with respect to the above the obligations will only apply for transactions entered into after 3 January 2018.

5. Transitional provisions

Application of product governance requirements to the distribution of products that were manufactured before the entry into force of MiFID II (issue of grandfathering).

When reading the ESMA Consultation Paper of 5 October 2016, it seems that ESMA takes the view that products which have been manufactured before 3 January 2018 that will still be distributed to investors thereafter fall immediately in to scope of product governance requirements applicable to distributors. We refer to paragraph 56 on page 32 (Annex 3 of the Consultation Paper) respectively paragraph 40 on page 12 of the Consultation Paper. ESMA seems to indicate that manufacturers should assign the target market according article 16(3) of MIFID II following their regular review process.

ESMA seems to indicate that immediately after 3 January 2018, a (provisional) target market must be in place by the distributor. This determination of target market by the distributor will probably have to be amended when the manufacturers have assigned the target market in the review process. This gives an unnecessary burden on distributors because they will have to determine target markets for all investments products very soon and twice. This will also give much tension on the implementation process because a provisional determination of the target markets for all products distributed before January 3, 2018, has to take place. This will not add to the quality of the implementation.

We question whether ESMA has the mandate to issue as a guideline (level 3) a so far reaching requirement. The approach followed by ESMA is also contrary to and deviating from the EBA-guidelines on product oversight and governance arrangements for retail banking products (EBA/GL/2015/18). The EBA-guidelines will only apply to all products brought to the market after the

implementation date thereof respectively to existing products that are significantly changed thereafter.

We do not agree with the statements made by ESMA. We do not see why distributors like the manufacturers should not get the same time to determine a target market based on the review process. It will already be a big challenge to have policies, procedures and business requirements with regard to product governance in place before January 3, 2018. To have the target market in place for each product for that date is too far reaching and will endanger the quality of the implementation. Therefore it is important that distributors like manufacturers can determine the target market for existing investment products at the moment that the first regular review of these products occurs. The determination of the target markets for the products manufactured/distributed before January 3, 2018, should be done when the (group of) investment products are up for the review process by the manufacturer. This will also enable for manufacturers and distributors to align their target market determination already from the beginning. To the extent there is no product manufacturer that falls within scope of MiFID II, the distributor should be able to determine the target market in accordance with its own regular review process.

6. Other issue

Deposit Guarantee Scheme

In annex 4 of the Consultation Paper some illustrative examples and case studies are given. Case study 2 (page 37) relates to structured deposits. This example assumes that an investor has recourse to the Deposit Guarantee Scheme in the event that the Issuer fails¹⁵. We question if this assumption is correct. Is the structured deposit as described not excluded from the definition of a deposit (article 2(1)(3) DIRECTIVE 2014/49/EU)?

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¹⁵ 6, page 38