

05 January 2017

European Securities and Markets Authority
103 rue de Grenelle
75007 Paris
France

Re: Consultation on draft guidelines on MiFID II product governance requirements

Dear Sir or Madam,

CFA Institute appreciates the opportunity to respond to this consultation paper on draft guidelines on MiFID II product governance requirements.

CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behaviour in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 140,000 members in 150 countries and territories, including 133,000 Chartered Financial Analyst® charterholders, and 147 member societies.

Specific Comments

Question 1 – Do you agree on the list of categories that manufacturers should use as a basis for defining the target market for their products? If not, please explain what changes should be made to the list and why.

When identifying the potential target market for their products, ESMA suggests that manufacturers consider the following categories in making this determination:

1. The type of clients to whom the product is targeted (e.g. retail, professional or eligible counterparty).
2. The knowledge and experience of the client.
3. The financial situation of the client, in particular, their ability to bear losses.
4. The risk tolerance of the client and the compatibility of the risk/reward profile of the product.
5. The clients' objectives.
6. The clients' needs.

CFA Institute agrees that the six categories above comprise a holistic approach to identifying the target market. However, we have a concern that, whilst these categories are suitable for distributors of investment products who have direct links with end-clients, some of the criteria may not be applicable for manufacturers. Typically, manufacturers do not have relationships with end-investors and thus are not well placed to assess specific client needs and circumstances. That does not preclude manufacturers from working with distributors to understand the type of clients that distributors would market certain categories of products to, and incorporating that information into product development. This approach helps to align interests and expectations between manufacturers and distributors and supports investor protection.

However, on balance, we believe point 3 (financial situation of the client, i.e. the ability to withstand losses), 4 (the risk tolerance of the client, i.e. the willingness to withstand losses), and 6 (other specific client needs) may be too granular for a manufacturer to take into account effectively when designing the product. These points can only be fully considered with detailed knowledge of client circumstances, and are therefore difficult for manufacturers to incorporate into their product development processes. Furthermore, discussions with investment professionals have revealed that the risk tolerance of a client can meaningfully differ from their ex-ante stated ability to sustain a loss, and can evolve over time depending on changes in their private, professional or financial situation, implying that only advisers can truly understand the individual needs and nuances of the end-client.

ESMA does acknowledge this difficulty for manufacturers in its consultation paper, and suggests manufacturers use theoretical knowledge and past experience of the product. Nevertheless, we still have concerns about the application and thus meaningfulness of the specific points raised for manufacturers.

In sum, we believe the design of a product, for a manufacturer, should depend on a basic distinction between client types (point 1), product complexity (point 2) and the expected objectives of potential investors (point 5). Risk tolerance, financial situation and client needs are, of course, critical considerations, but are best made at the distributor level.

Question 2 – 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.

Paragraphs 18-20 of the draft guidelines propose that the identification of the target market assessment should be done in “an appropriate and proportionate manner, considering the nature of the investment product.” As elaborated on in the background to the draft guidelines, this suggests that for simpler, more common products, the target market could likely be identified with less detail.

However, we caution that the target market assessment for seemingly non-complex products is not always straightforward. For example, the complexity of a passive equity ETF (e.g. a UCITS) may depend on factors such as replication methodology (e.g. full replication vs. optimization), instruments used (e.g. cash equities vs. derivatives), counterparty risk (if done through derivatives), the use of leverage or securities lending, and so on. In this regard, the aspects relating to proportionality of the target market assessment could be linked to ESMA's guidance on complex products.

Question 3 – Do you agree with the proposed method for the identification of the target market by the distributor?

Under ESMA's proposals, distributors would be required to identify the target market using the six categories described in Question 1 as a starting point. Due to their closer relationship to clients, it is expected that distributors would be able to define the target market in a more granular way, including by using analysis of current and potential clients, as well as other data that may be useful, such as suitability questionnaires, customer relationship management activities, anti-money laundering questionnaires, and so on.

CFA Institute agrees with the proposed method for the identification of the target market by the distributor and reiterates its belief that distributors are better suited to this role than manufacturers. The comprehensive target market assessment expected to be carried out by distributors seems to us to justify our concerns about burdening manufacturers with detailed target market assessments summarised in the response to Question 1.

Question 4 – Do you agree with the suggested approach on hedging and portfolio diversification aspects? If not, please explain what changes should be made and why.

ESMA notes that some products may be desirable for investors not necessarily for their own sake but in the context of a broader portfolio strategy. The target market assessment proposed by ESMA is, however, product-related and any unique features of clients should be considered at the individual point of sale. In some instances, it may be determined that a product is suitable for investors outside the identified target market. ESMA's proposal is to allow these deviations but notes that these should be justified by the individual facts of the case and should not occur on a regular basis. Sales outside this target market should be reported to the manufacturer so that they may reconsider, if necessary, the design of the product.

CFA Institute broadly agrees with this proposed approach to permitting, on a case-by-case basis, deviations from the target market. However, we note that this approach appears susceptible to abuse. We therefore suggest that a threshold be considered (e.g. an immateriality threshold) so that sales outside the target market cannot breach a certain proportion of overall sales of the product, or, cannot constitute some proportion of the investors' invested capital.

Question 5 – Do you believe further guidance is needed on how distributors should apply product governance requirements for products manufactured by entities falling outside the scope of MiFID II.

ESMA proposes that in cases where firms are distributing products manufactured by entities not subject to the MiFID II product governance requirements, the distributing firm is expected to perform the necessary due diligence, including target market assessment, before distributing the product. CFA Institute agrees with this position.

Question 6 – Do you agree with the proposed approach for the identification of the 'negative' target market?

ESMA proposes that as part of the target market assessment by manufacturers and distributors, a 'negative' target market is also determined using the same categories listed for the positive target market assessment. The purpose of the negative target market is to explicitly identify investors for whom the product is not suitable. Sales of the product to investors in this category should not occur. In summary, the target market identification process would result in a positive target market, which is the priority for distribution, 'other investors' that may be eligible to purchase the product on a case-by-case basis (e.g. for hedging purposes as in Question 4), and a negative target market, which should not be purchasing the product.

CFA Institute supports the identification of a negative target market. We believe that explicitly identifying an essentially not-eligible subset of investors should reduce the case-by-case subjectivity involved in sales to non-positive-target market investors.

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

CFA Institute agrees with ESMA's treatment of professional clients and eligible counterparties in the wholesale market.

Question 8 – Do you have any further comment or input on the draft guidelines?

CFA Institute wishes to express some reservations about the direction of travel in product governance. The regulatory approach has tended to continuously place ever increasing emphasis on obligations of the firms manufacturing and distributing financial products. While this is a correct area on which to focus and is necessary for investor protection, we believe there may be diminishing returns to this approach, especially if it were to crowd-out regulatory efforts to address the underlying issue of (a lack of) customer knowledge. We believe that improving investor knowledge is an unavoidable necessity if we wish to improve investors' ability to protect themselves from unsuitable investments and are concerned that, at some future point, layering ever more stringent product governance obligations on manufacturers and distributors will yield little marginal benefit.

Concluding Remarks

CFA Institute welcomes the opportunity to comment on draft guidelines on MiFID II product governance requirements. Please do not hesitate to contact us should you wish further elaboration of the points raised.

Yours faithfully,



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