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ESMA CONSULTATION ON DRAFT GUIDELINES ON PRODUCT GOVERNANCE REQUIREMENTS

ESMA/2016/1432

SPANISH CONFEDERATION OF SAVINGS BANKS AND SPANISH BANKING ASSOCIATION RESPONSE

The Spanish Confederation of Savings Banks and Spanish Banking Association welcome the *ESMA consultation on draft guidelines on product governance requirements* and do appreciate the opportunity to provide arguments on the different issues included in the Consultation Document.

The Spanish Banking Industry welcomes the regulators' intention to establish standards to regulate product governance and, in particular, the definition of the target market, by manufacturers and distributors. It is convinced that this will benefit the sector by making it more robust and more trustworthy for society as a whole.

TARGET MARKET PROPOSAL FROM INDUSTRY

Given the importance of the definition of the Target Market for Spanish industry, on its own initiative, the joint work group CECA-AEB developed a proposal that was submitted to the CNMV and CE and we want now to extend to ESMA. This proposal (in Annex I) has been adapted to recent developments, specially the ESMA consultation and our response.

In this proposal, the Spanish industry remarks how essential is to distinguish clearly between the different roles of the main actors (manufacturers and distributors) in order to assign them only those responsibilities that correspond to them, and to avoid a rise in litigation over products, which would not benefit any of the interested parties, including customers and supervisors.

In short, in our judgement, the identification of the target market done by the manufacturer for each instrument must necessarily be generic and the distributor's checking of whether the end customer is compliant or not will hinge on the distributor's role, depending on the investment service provided.

Hence, in Annex I we present a proposal on:

- The generic target market to be defined by a manufacturer
- Development of the target market to be defined by the distributor (on the basis of the generic target market provided by the manufacturer), depending on the investment service provided to the customer.
    - In execution only or intermediation
    - In services where appropriate test applies
    - In investment advice

GENERAL COMMENTS REGARDING THE CP

As a general comment, the content of the draft guidelines could go beyond their initial purpose (i.e. to clarify/interpret certain concepts/provisions). In particular, we believe that these guidelines substantially develop the target market provisions, creating new obligations for investment firms which do not appear in the Level 1 and 2 rules. Furthermore, the language used by ESMA ("manufacturers **should** use", "the manufacturer **should** define", "distributors **should** conduct", etc.) is of a compulsory nature. In this respect, these guidelines are not legally binding and, as such, their purpose should be to clarify certain aspects of the Level 1 and 2 rules, to provide guidance/recommendations (not compulsory requirements) to the industry and to promote a common approach across the EU. In addition, we understand that this kind of language could create legal uncertainty as it may be used against investment firms in potential complaints or judicial proceedings. Another unintended consequence of the Guidelines could be to impose limitations that would restrict the provision of investment services not provided in Level 1.

In short, this document should provide guidance for investment firms, but they should be able to decide how apply the categories included in the Guidelines depending on the service provided (i.e. one, three or the six categories as deemed appropriate).

Our main concerns are summarized in:

- **Relation between investment services and categories identified for each product:**

Furthermore, **the level of detail required by the draft guidelines goes well beyond the Level 1 and Level 2 rules**. In our opinion, defining the target market in consideration of the six categories identified in the Consultation Paper implies, in practice, the assumption that the relevant financial instrument will be distributed under investment advice or portfolio management, as it is precisely under these investment services where an investment firm is obliged to obtain detailed information of its client in order to assess if the relevant product is suitable considering the client's knowledge and experience, financial situation and investment objectives. In fact, the draft guidelines introduce new factors that would not even be considered when providing investment advice (i.e. client's needs) and, therefore, this information would never be available to the distributor. Much less should be considered when

providing access, at a competitive price, to a wide range of financial instruments that are likely to meet the needs of the clients.

In this respect, paragraph 39 (page 28) of the draft guidelines seems to identify this problem and states that where firms carry out services that only require the assessment of appropriateness they should consider that they will usually be able to conduct an assessment of the actual target market, limited to the sole categories of knowledge and experience of clients. However, the Consultation Paper does not give a solution to this kind of situations, conversely, it states throughout the document that it should be ensured that the product ends up with the type of customers for whose needs and objectives it has been designed (something which will only be possible if the service provided is investment advice or portfolio management).

Consequently, we believe that the draft guidelines proposed by ESMA **(a)** impose, in practice, the obligation to investment firms to provide investment advice to their clients[1] (what contravenes Level 1 & 2 that enable firms to decide the service to be provided); and **(b)** the effectiveness of any sale to a client could be challenged before the courts on the basis of the product not meeting the six categories/elements proposed therein (elements that would be assessed by a court on an individual basis, although the determination of the target market would have been done on a general basis, considering a universe of clients), even when investment advice was not provided and the client clearly understood the product. Another example of the previous argument arises from the combination of Guideline 39 and obligations established in PRIIPs. Guideline 39 states that *"… when distributors define their product assortment, (…) they pay particular attention to situations where they might not be able to conduct a thorough target market assessment by virtue of the type of services they provide*".

So, in the case of non-advised services, this guideline establishes " In particular, *where firms only carry out execution services with the assessment of appropriateness (for example through a brokerage platform), they should consider that they will usually be able to conduct an assessment of the actual target market, limited to the sole categories of knowledge and experience of clients; where they only conduct execution services under the execution-only regime, not even the assessment of clients' knowledge and competence will usually be possible",*

In practice, this could mean to eliminate from the firm offering any product with a target market defined in terms of categories designed for advised services, if it is only providing non-advised services. However, if we cross these guidelines against PRIIPS Regulation, this

[1] This may be inferred, for instance, from paragraph 32 (page 10) of the Consultation Paper where the following is stated: "*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). Indeed, it would be expected that, if the ex-ante target market identification is correctly conducted, recommending and/or actively marketing products outside the target market, even if based on the consideration of the specific client's features, should be a limited occurrence*."

possibility will convert into an obligation as according to Article 8.3.c must be included "*a description of the type of retail investor to whom the PRIIP is intended to be marketed, in particular in terms of the ability to bear investment loss and the investment horizon".* These two elements are only known when the firm is providing investment advice and therefore PRIIP products could not be offered under non-advised services. This implicit restriction is not established in MIFID II Level 1&2 nor in PRIIPs Regulation.

We understand this as an unintended consequence of a complex regulatory framework, so we strongly believe it is necessary for the guidelines to clearly indicate which categories of the target market the distributor should check based on the service provided and what kind of information should be given to the client regarding the non-verification of one of the categories that the manufacturer has defined. (See Annex I)

- ***Articulation between the distribution strategy of the manufacturer and its definition of the target market*:**

Another example of breaching Level 1 is included in the "*Articulation between the distribution strategy of the manufacturer and its definition of the target market*" **(paragraphs 19-21 of the Background and par 22 of the guidelines).**

We do not agree with the requirement introduced by ESMA that the manufacturer should propose the type of investment service and channel through which the defined target market could buy the product. Distribution channels are constantly changing because of digitalization and distributors have a better knowledge of the channels to should de used for a certain product than manufacturers. The requirement to follow the manufacturer's recommendation on this matter considerable restricts the distributor´s capability to choose the type of invest service or the channel for a particular.

Distribution strategy should not be defined as "investment service" as there is no legal basis for this interpretation. The identification between "distribution strategy" and "investment service" should be done at level 1 regulation.

If ESMA insists on defining in the Guidelines what the "Distribution strategy" is, should be limited to the **possible** distribution channels (face-to-face, via telephone, online, etc.) in order to avoid conferring the manufacturer some attributions that, in our opinion, do not correspond to him, such as specifying the acquisition channel or designing a specific channel for the sale of the product. (See response to Q3)

Nowadays, banking networks are the main distributors of financial products in Europe. They are professional entities that maintain different distribution and communication channels with their customers. It is up to these distributors to determine if a channel is suitable or not, depending exclusively, that that channel allows compliance with the rules of conduct. This

should therefore fall within the scope of the distributor's decision.

All of the foregoing shows that it is not easy to maintain that the manufacturer requires the distributor a service - investment advice - or concrete channel - physical presence - without limiting the ability of the distributor to act and decide in a way not clearly compatible with Level 1 rules.

- **Treatment of the deviations from the target market described by the manufacturer:**

The target market set by the manufacturer should not limit the distributor's ability to make his own decisions about the appropriateness of the sale, when they are required and committed to apply their professional judgment. Therefore, it is proposed to remove the reference that deviate from the target market described by the manufacturer can only be done in restricted cases, as well as requirement that it is considered a "good practice" the general observance from the distributor of the target market identified by the manufacturer.

Of course, we do not deny that the withdrawal must be justified. But not to the point that it is forbidden. From our point of view, this is not derived from MIFID II.

In any case, it is necessary **that the definition of Target Market**, as it will be developed in the following questions, is clearly defined and delimited, as far as possible, **according to the most standardized criteria possible**, otherwise the risk that such categories would be defined differently by manufacturers and distributors would mean that neither the comparability of the financial instruments nor the distributors would receive homogenised information, which would seriously hamper the definition of the target market that they must also carry out.

In addition, throughout the document, it is stated **that a proportional approach should be applied**; however, in our opinion, this proportionality is not achieved, as it is explained in detail in Q2.

Q1: Do you agree with the list of categories that manufacturers should use as a basis for defining the target market for their products? If not, please explain what changes should be made to the list and why.

In respect of the categories specified in the Consultation Paper, as a general comment, we would suggest that **further standardization should be included in each of the categories** so as to facilitate the reporting and controlling between the distributor and the manufacturer and vice-versa. We fear that certain examples used by ESMA in each category may be difficult to match between the manufacturer and distributor. For instance, in case the manufacturer says that a product is “conservative” under the category risk tolerance, it may not match the

"conservative" definition of the manufacturer because they may have different concepts of what is conservative (bearing 50% of losses? Bearing 30 % of losses? Etc.).

The whole list of criteria should only be fulfilled by the distributor when providing investment advice. It is of particular concern that when determining whether a given customer is part of the target market, a distributor had to obtain information about several aspects (ability to bear losses, time horizon, etc.) that are known when providing an investment advice service or portfolio management. Contrary to what ESMA suggests, the distributor is unable to gather certain information needed to assess the target market under execution only.

Furthermore, we would also suggest deleting the following last sentence from paragraph 22 of the draft guidelines: "*Additional categories should be added if the manufacturer regards them as important to define the target market of the product."* The reason for such deletion is to simplify the definition of target market and the coordination between the manufacturer and distributor. If for each product the manufacturer could introduce any other additional category that he considers relevant, it may create additional lists of criteria to be fulfilled by the distributors. Therefore the outcome will complicate even further the product governance requirements.

In respect of the particular categories specified in the Consultation Paper:

1.- Type of clients to whom the product is targeted: Seeking the standardization needed, categories of the type of client should be defined as those defined in MiFID, ie, retail, professional and eligible counterparties. It should therefore be avoided that additional categories such as those indicated in the Guidelines or similar can be given, as there is no harmonized definition of them, which would imply a great uncertainty in their interpretation, both for the distributors themselves and as well as by potential investors.

2.- Financial situation with a focus on the ability to bear losses: The manufacturers would be in a position to define this category to the extent that it is limited exclusively to the client´s appetite for bearing losses. Any other classification would add uncertainty as it is not defined in any other rule.

3.- Knowledge and Experience: We disagree with the explanations included in the Guidelines related to knowledge and experience. Manufacturers should limit to define if prior knowledge and/or experience of the product or products of a similar nature and risk is required not. (See answer to Q3 and Annex I)

4.- Risk tolerance and compatibility with the product risk profile: In respect of the risk tolerance, the draft guidelines require firms to use the risk indicator stipulated by the PRIIPS Regulation, where applicable, to fulfill this requirement. ESMA should allow the use of others existing "regulatory" indicators as UCITs and not only the PRIIPs risk indicator as it is currently stated. For products where no "regulatory" indicator applies, only general classifications like

"high" "medium" and "low" should apply in order to avoid infinitive models regarding different manufacturers.

To evaluate the compatibility of risk tolerance and product risk profile is needed to consider the portfolio of the client as a whole, taking into account diversification effects to assess suitability. As in the case of, knowledge and experience, convergence with current suitability test already implemented by distributors should be required to avoid unnecessary burden

5.- Clients' Objectives & Clients' Needs: In our opinion, these two categories incorporate a high degree of subjectivity when being defined by the manufacturer. In fact, it may be impossible for the distributor to obtain this information in a homogeneous way according to the different categorizations potentially defined by the manufacturers.

Not surprisingly, in parr. 12 of the Background section, ESMA states: *The manufacturer usually does not have a direct client contact and thus has no detailed, specific and individual information about the client base. Hence, its target market identification may be more abstract in the above-mentioned categories.* Objectives and Needs are terms that seem too ambiguous to fall into the sphere of determination of the manufacturer.

Therefore we believe that these categories should be replaced by a single one that would be the investment horizon, which is a category that is described in the guidelines as being part of the Client's Objectives. The length of the investment is a category that clearly delineates the investors to whom the product is designed. This proposal, as we have stated previously, would be also compliant with PRIIPs Regulation.

Q2: Do you agree with the approach proposed in paragraphs 18-20 of the draft guidelines on how to take the products' nature into account? If not, please explain what changes should be made and why.

We are in favor of a proportional approach considering not only the complexity of the particular product, but also the type of client to whom it is addressed and the service provided

For the more common and less complex products the description of the different categories necessary to identify the target public should be more generic. And obviously more complex products would require a more detailed definition, as described in points 16 to 18 of the Background. However, we believe that the wording of paragraphs 18-20 of **the guidelines does not clearly reflect this idea and should contain the content of paragraph 17[2] of the background within the guidelines**.

[2] Paragraph 17 of the Consultation Paper on Draft Guidelines on MIFID II product governance requirements (p. 7) and in ESMA's technical advice to the Commission on MIFID II and MIFIR (p.51): "*ESMA considers that it would be inappropriate to specify in too much detail the level of granularity that*

Notwithstanding the above, we believe that the proposal contained in the Consultation Paper does not properly include a proportionality approach. In our opinion, this proportionality means that in some cases it may make sense to go through the different categories and/or to provide a more detailed description, while in other cases, particularly in relation to non-complex products or non-retail clients the definition of the target market should not necessarily include the assessment of all the categories proposed. For instance, in the case of ordinary shares, as already noted, it is considered that these are compatible with the mass retail client. Therefore, it should be sufficient to specify that the product may be addressed to retail clients in general.

In particular, the proportionality approach should be pursued from a threefold perspective:

(i) **From the product perspective:** Depending on the complexity of the relevant product the target market should be described with more or less detail, not being necessary in all cases to address each of the six categories proposed in the draft guidelines. For instance, certain products are considered to be compatible with the mass retail client (i.e. ordinary shares, as already mentioned) and, therefore, they should not need a detailed identification of the target market. In these cases, it makes no sense to assess the six categories proposed and it should be sufficient to specify that the product may be addressed to retail clients in general. Otherwise, contradictory situations could arise. For instance, in the case of ordinary shares, as already noted, it is considered that these are compatible with the mass retail client, however, if investment firms have to specify the risk tolerance of the target market this could significantly reduce the target market as this kind of product normally would have a high risk. We understand this would not make much sense when it is a simple product, well known by the retail investor universe. In addition, ordinary shares are usually distributed under execution-only regime so firms will generally not be able to carry out any verification.

Also, there are cases in which the categories proposed by ESMA do not seem to fit with certain financial instruments. This is the case, for instance, of products distributed for hedging purposes where the following categories do not make much sense:

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is required, since this will vary according to the specific circumstances. For simpler, more mainstream investments, such as ordinary shares, it is likely that the target market will be identified with less detail. In many cases, it is understood that such products can be considered to be compatible with the mass retail market. For more complicated, less mainstream investments, such as contingent convertible securities or structured products with complicated return profiles, the target market should be identified with more detail. In this context, the criteria used to define the target market and determine the appropriate distribution strategy must be relevant for the product."

- The ability to bear losses as the potential losses that the client may suffer would be compensated by a lower cost in the client's hedged risk[3].

- The risk tolerance of the client would not be considered in these cases as, what is relevant, is the fact that the client is exposed to a particular risk which is precisely the one intended to be mitigated with the financial instrument.

(ii) **From the client perspective:** The level of detail in which the target market is formulated should vary depending on the type of client. The Consultation Paper specifies that, when carrying out their target market identification, firms should consider the differences between retail and professional clients, for instance the differences in the knowledge and experience profiles of these categories. However, we believe this approach is not sufficient. In accordance with Article 54. 3 of the Commission Delegated Regulation of 25/04/2016, investment firms are entitled to assume that their professional clients: **(a)** have the necessary level of experience and knowledge to understand the risks attached to the particular products; and **(b)** are able financially to bear any related investment risks consistent with the investment objectives of that client.

In view of the above, we believe that the following approach would make more sense: the identification of the target market should be more detailed in the case of retail clients (although the level of detail and assessment of one or more categories will depend on the type of product and service provided). Thus for professional clients in no case should all the six categories be required when defining the target market (for instance, firms should not be required to consider/assess the knowledge and experience and the financial situation as the Level 2 rules entitles them to presume these are satisfied). Otherwise, if firms are obliged to consider the six categories when identifying a professional target market, this would only result in an administrative burden as, in practice, firms will not verify all these factors. Therefore, this would not be in the interest of the client in any way, thus it poses a risk for investment firms as it could be used against them in potential litigations.

In addition, with regards to eligible counterparties, and due to their nature and experience in financial markets, we believe that the requirements on target market identification should be kept to a minimum, i.e. it should be sufficient to specify that a product is addressed to eligible counterparties without assessing or considering any additional categories. As said, these counterparties have broad knowledge and experience in financial markets; thus many of these firms are authorized to provide investment services to other entities so they should be treated as equals. Moreover, this

[3] *Hedge item may be a balance sheet element, firm commitments or net investments. The hedge risk may be related to rates, inflation, fx, equity or commodities prices movements. Clients hedge risks related to their balance sheet and/or activity.*

kind of counterparties is authorized and subject to their own regulation which in certain cases imposes certain financial requirements for which they may conclude transactions in financial instruments. In this respect, it may be difficult for investment firms to identify their investment objectives/needs as they are not (and have no obligation to be) familiar with such regulation applicable to their eligible counterparties. Without prejudice to the above, if firms were finally obliged to provide a detailed target market for eligible counterparties, taking into account that in practice no verifications will be carried out in respect of the different factors, this would only imply: (a) an administrative burden for investment firms; (ii) a risk as it could be used against firms in potential litigations and (iii) an extra-cost to be paid by the final client. Otherwise, if entities were not only obliged to describe in detail the target market, but also to conduct checks, this would constitute an administrative burden with no benefit for the client (in fact, the activity would lose the agility required by these counterparties) and could negatively affect EU entities when trading with non EU entities.

As a consequence, the general rule should be that the target market identification requirements should be kept to a minimum with regards to professional clients and eligible counterparties. If these clients/counterparties are willing to receive the same level of protection granted to retail clients they can request so.

(iii) **From the investment service provided perspective:** MIFID 2 imposes the obligation to assess the appropriateness or the suitability of the relevant product for the client, or excludes the need to carry out such assessments, depending on the service provided by the firm. This is, the Level 1 and Level 2 rules clearly identify certain cases in which it is considered that a greater protection to the client should be granted and cases in which this is not necessary. The target market provisions should not contravene these rules and, therefore, a proportional approach should also be undertaken on the basis of the service provided so that the different categories proposed in the draft guidelines may or may not be developed /assessed depending on the investment service offered. For instance, if a firm distributes a product on a non-advised basis, we do not see the point to require the identification of the six categories when the firm will not be able to check if all these factors are met in each individual sale. This is especially relevant in those cases where manufacturer and distributor is the same entity and, therefore, from the beginning, the firm knows with certainty the distribution strategy that will be adopted. In these cases, the assessment of all the categories would merely constitute an administrative burden if the firm knows that the product will be distributed on a non-advised basis and, at a later time, a major cause of problems before the courts and regarding any potential complaints.

In short, in our opinion, the identification of the target market done by the manufacturer for each instrument should be necessarily generic. Additionally, the

distributor's verification of whether the relevant client is included in the target market will depend on the investment service provided by him.

In our opinion this proportionality approach is in line with the spirit of the Level 1 and 2 rules which is summarized in recital 18 of the Delegated Directive of 07/04/2016: "*In light of the requirements set out in Directive 2014/65/EU and in the interest of investor protection, product governance rules should apply to all products sold on primary and secondary markets, irrespective of the type of product or service provided and of the requirements applicable at point of sale. However, **those rules may be applied in a proportionate manner**, depending on the complexity of the product and the degree to which publicly available information can be obtained, **taking into account the nature of the instrument, the investment service and the target market**. Proportionality means that these rules could be relatively simple for certain simple, products distributed on an execution-only basis where such products would be compatible with the needs and characteristics of the mass retail market.*"

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

From our point of view, it could be improved according to the type of service provided. If an investment firm does not provide investment advice or portfolio management it will not be able (and will have no obligation) to identify/verify certain factors and, therefore, the definition of the target market in too much detail would constitute an administrative burden and pose the risk of increasing litigation.

While in some cases the distributor may be able to gather all the relevant data from an existing client to identify the target market fulfilling all the relevant criteria, in other cases such as for potential clients where no advice is provided, certain information (ability to bear losses, time horizon, etc) will not be available and therefore the distributor will not be capable of verifying whether that client belongs to the identified target market of the product. We therefore suggest that ESMA amends its guidelines to clarify that under execution only and appropriateness, the distributor may not be able to gather information from the client on all six cumulative criteria. Therefore the assessment of the target market will be done based on fewer criteria or issuing a warning as explained below.

Some paragraphs of the consultation paper give the impression that the distributor will have to gather information even under execution only (see for instance reference to footnote in page 11 of the consultation paper). In order to clarify this situation, we would thus suggest that ESMA prioritizes the idea behind the following paragraph from the draft guidelines:

"42. Moreover, taking into account that the client's protection decreases when information available is not sufficient to ensure a full target market assessment, distributors may also

*decide to let clients operate on a non-advised basis after **having warned them** that the firm is not in the position to assess their full compatibility with such products."*

By highlighting the idea in paragraph 42, the distribution under execution-only or appropriateness should be allowed to operate warning the investor that the distributor was unable to assess certain criteria of the target market and therefore it is the ultimate decision of the client to invest or not in that particular product.

Otherwise, an additional risk would arise: as the firm would have obtained the necessary information to fulfill the target market provisions, it could be interpreted that it is obliged to use such information in the best interest of the client and, therefore, it could be considered that investment advice has been provided. In order to mitigate this risk, investment firms may be forced/decide to start providing investment advice on a general basis. In this respect, we would like to highlight that investment advice is not always the best option for investors.

Regarding Knowledge and Experience, which also relates to our response to question 1, we disagree with the explanations included in the Guidelines. Since the implementation of MiFID I, distributors had implemented a full framework to evaluate knowledge and experience in order to assess the appropriateness of a specific financial instrument. We fear that the way the producer will define the "Knowledge and Competence" may not match the definition/clarification already used by distributors. We would therefore request that the models used to evaluate "Knowledge and Experience" already put in place by distributors are not restricted by the definition of the target market by the producer.. We would also highlight that distributors are the ones with "know your client" obligations and the ones who are in a better position to evaluate the "Knowledge and Experience" of the final client.

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.

In our opinion, the approach on hedging and portfolio diversification aspects is insufficient. The Consultation Paper correctly identifies the problem (i.e. the same product may be used to meet different objectives/needs), but in our opinion it does not properly address the situation. What is relevant is to assess/determine what categories/factors are determining in these cases and should, therefore, apply.

It is extremely difficult to find a set of common categories that may be applicable in relation to all types of products. As explained in Q.2, when products are intended to be distributed for hedging purposes, some of the categories proposed in the draft guidelines do not make sense and, therefore, should not be assessed by manufacturer and distributor or at least assessed in a different way:

- The ability to bear losses: this category is not relevant when a product is intended to be used for hedging purposes as the potential losses that the client may suffer would be

compensated by a lower cost in the client's hedged risk. For instance, in the case of a client that concludes an interest rate swap linked to Euribor in order to mitigate the interest rate risk arising from a loan linked to the same Euribor reference, any negative settlement that may result from the IRS will be compensated by a lower amount of interests paid by the client under the loan. If ESMA considers that this approach is not correct specific guidance and examples in this respect would be welcomed.

- The risk tolerance of the client: this factor should not be considered in these cases because what is relevant is the fact that the client is exposed to a particular risk which is precisely the one intended to be mitigated with the financial instrument. In the example above what is important is the fact that the client is exposed to the interest rate risk as a result of the loan being linked to Euribor. For instance, a client that has a low tolerance risk is usually the one who will prefer to hedge its positions, however, in courts it has been already understood that a derivative corresponds to an aggressive risk tolerance profile.

In short, we believe that the proportionality approach and ESMA's intention to consider the different nature and characteristics of certain products should not only be materialized in the inclusion of additional indications when assessing the target market or a more/less detailed description, but also in assessing what categories/factors are relevant and should therefore be developed/analyzed, and which not.

In addition, regarding paragraph 30 (background) it should be made clear that when a firm has complied with the requirements applicable to the particular investment service that has provided (appropriateness test or suitability test (where applicable), providing pre-trade information, management of conflicts of interests, etc.) the sale of the product should be presumed to be valid, binding and correctly undertaken.

The fact that there is a deviation from the target market defined by the manufacturer, although the distributor has carried out all its legal obligations should not be perceived as an incorrect or irregular sale. We are concerned that some of the statements contained in the Consultation Paper could lead to the idea that if an individual sale deviates from the target market means that such sale has not been correctly undertaken. Especially considering that the target market identification is made on a general basis (taking into account a universe clients), while the particular sale is made on an individual basis and fulfilling all the legal requirements imposed by the Level 1 & 2 rules. An explicit safe-harbor in this respect would be needed.

By definition portfolio management is mainly about diversification of a basket of investments across different classes of securities, sectors of the economy/ geographical regions bearing in mind the client´s objectives and risk profile. Moreover, portfolio managers are able to do an in-depth assessment of the client –where the product manufacturer cannot- when providing investment advice or portfolio management. Considering that proper portfolio diversification

is key to any client, independently of its characteristics or objectives, regulatory changes should promote it instead of inhibiting it. Diversification is a result of combining different risks, meaning that products with different characteristics and, a priori, with different target markets may be suitable when assessed within a portfolio approach.

The Guidelines should grant more flexibility with respect to the target market identified by the manufacturer, to those investment firms performing investment advice according to a portfolio approach, provided, of course, that all other applicable legal requirements are fulfilled, and that the distributor provides the manufacturer with ex ante information about the portfolio approach provided by its investment services model. Provision of investment advice pursuant to the operating model described above – jointly with all other applicable legal requirements – would represent an effective instrument for investment firms for managing their possible conflicts of interest as distributors, also enhancing the degree of protection granted to clients through the implementation of systems for suitability assessment preventing clients from carrying out any transactions which have been considered as unsuitable for them (so called "blocking suitability").

We would propose that when the distributor is providing investment advice or portfolio management, the cases of hedging and portfolio diversification should **not** be considered as deviations from the target market of the manufacturer and therefore should not be reported.

On top of it, we would request to specify what does “recurrent” mean so as to report the deviations from the manufacturer’s target market. For instance, there may be the case that a portfolio manager includes a risky fund (this will imply a deviation from the producers´ target market of that particular fund) within a basket of low risk securities and then sells this mix of assets to several clients with the same risk profile. Should the asset manager report once this deviation, or should it be reported per client? There are too many practical challenges associated to this requirement**.**

We disagree with what is reflected in parr. 31 of the background, which implies that the products to be incorporated into a given portfolio are those that have the same or lower level of risk than that determined by its profile. We also disagree with the statement, as indicated in parr. 32 of the background, that the inclusion of a higher risk product, even if the aggregate risk of the whole portfolio is lower than the profile of the portfolio, should be considered as an isolated element that cannot occur on a regular basis. The suitability of a portfolio should be determined by the combined effect of all the products that comprise it, so that if the resulting risk level is equal to or lower than that determined by the suitability test, the portfolio is considered to be suitable, regardless of the level of each individual product.

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

In our opinion, it is not clear what the following statement means: "This means that the distributor has to define its own target market for such products and the distributor should **conduct the necessary information gathering process to form and adequate basis to fulfill this obligation**". We understand that the aforementioned only refers to the collection of complete information on the characteristics and functioning of the product in order to be able to identify a target market, but clarification would be welcomed.

We disagree with the draft guideline under paragraph 56 where it states that products which have been manufacturer before 3 January 2018 but which are distributed to investors after 3 of January 2018 should fall within the scope of product governance requirements applicable to distributors, in particular, the requirement to identify a target market for any financial product.

While manufacturers that produced before 3 of January are exempted (paragraph 55) from identifying the target market (until the review process cycle is applied), distributors are obliged to define by 3 of January 2018 the target markets of **all products** which are still being distributed but produced before the implementation date. This creates a disproportionate burden on distributors which will have to go through the process of data gathering and defining the target market by 3 of January 2018.

There is an important "legacy issue" here that should be clarified by regulators. Distributors should be given the same treatment as manufacturers. If manufacturers are exempted from identifying the target market for products existing by 3 of January 2018 until the review process, these products should be exempted from product governance requirements also for distributors.

If this is not the case, distributors should be bearing an unnecessary burden in favour of manufacturers. If this exemption is not recognised for products existing by 3 of January, we therefore suggest that manufacturers are the ones to define the target market for products existing before the 3 of January 2018 and still distributed.

Not only distributors should be bearing an excessive burden if they are the ones to define the target market but a really unintended situation could arise if this is the case: Distributors define a target market, and when the review cycle arrives, manufacturers could define a different one. The legal uncertainty created should leave distributors in a very vulnerable position.

Finally, when a manufacturer not subject to MIFID2 has wanted to apply these guidelines but with a result that the distributor deems inappropriate, the distributor should be allowed to define the target market without regard to the manufacturer's outcome.

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

When developing the concept of "negative target market" the draft guidelines should also apply the proportionality principle, specially taking into consideration that there will already be a positive target market determined and, therefore a greater level of protection will have been already put in place. For this reason, we believe that the negative target market requirements should be kept to a minimum and that entities should not necessarily go through all the categories.

In addition, we are concerned that the definition of a negative target market may put distributors in an especially vulnerable position. As already explained, depending on the service provided to the client, the investment firm will be obliged to gather (or not) certain client information; thus, they will not always be (and the Level 1 rules do not oblige them to be) in a position to verify if an individual client falls under the scope of the negative target market. To pretend otherwise would imply imposing firms the obligation to provide investment advice to their clients, what goes beyond the Level 1 and 2 rules.

As previously explained, this is relevant from the point of view of the positive target market; however, in the case of the negative target market it becomes particularly important as it may give rise to an increase of litigation in the event that a firm sells a product to a client included in the negative target market; even when the firm: **(a)** has completely fulfilled its legal obligations in respect of the service provided (appropriateness or suitability test (if applicable), pre-trade information, management of conflicts of interest, etc.); and **(b)** the client completely understands the characteristics and risks of the product.

For the sake of legal certainty, we insist on the fact that the guidelines should expressly recognize the validity of the transactions concluded when the investment firm has fulfilled the obligations required by the Level 1&2 rules for the particular service provided to the client, although that may mean that the investment firm will not have sufficient information to verify if a particular client meets the characteristics of the target market.

We would also like to highlight the following issues under paragraph 65 of the draft guidelines:

- ESMA should standardize the reporting mechanism from the distributor to the manufacturer of the deviations from the target market, when this reporting is needed in view of the service provided according our comments in Q5.
- ESMA should also define when a deviation should be considered recurrent (10 times per year, 20 times per year?) and the frequency of the reporting (monthly, quarterly etc).

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

- **Intermediation chain**: We believe that in order to determine if a client/counterparty is acting as an end-client or as part of the intermediation chain the distributor should be entitled to rely on the representation made by these clients/counterparties regarding the purpose of acquiring the products. We believe these kinds of clarifications are positive and should, therefore, be expressly included in the guidelines.

- **Proportionality:** In addition, we do not share the position adopted in the Consultation Paper as we understand that the proportionality approach is not correctly addressed. As explained in Q.2, the level of detail in which the target market is formulated should vary (among other factors) depending on the type of client.

  The Consultation Paper states that the general methods described in the guidelines may be adapted in several ways to take into account the special knowledge and experience rules applicable to professional clients and the fact that, for eligible counterparties, Article 24(2) of MIFID 2 does not apply, likely leading to a less comprehensive target market identification for them. However, we believe that the Consultation Paper does not provide a clear solution for this kind of counterparties, thus it does not provide sufficient legal certainty.

  As explained in Q.2, as per Article 54. 3 of the Commission Delegated Regulation of 25/04/2016, the approach should be the following: the identification of the target market should be more detailed in the case of retail clients, thus for professional clients not all the six categories specified in the draft guidelines should be required when defining the target market (at least, firms should not be required to consider/assess the knowledge and experience and the financial situation as the Level 2 rules entitles them to presume these are satisfied).

  In addition, with regards to eligible counterparties, and due to their nature and experience in financial markets, we believe that the requirements on target market identification should be kept to a minimum, i.e. it should be sufficient to specify that a product is addressed to eligible counterparties without assessing or considering any additional categories. Otherwise, requiring a detailed target market identification would only constitute an administrative burden and an extra-cost to be paid by the final client. In fact, in the activity carried out between two EU investment firms, this administrative burden would be duplicated as both entities would be subject to the target market provisions.

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

We have the following additional comments in relation to the draft guidelines:

- **Information gathering process (paragraph 52 of the draft guidelines).** ESMA requires that when the distributor cannot access all relevant information because is not publicly available (for example, through the PRIIPs KID or a prospectus), the distributor should take all reasonable steps to get the information which should include **entering into an agreement with the manufacturer** or its agent in order to obtain all relevant information enabling the distributor to carry out its target market assessment. We would kindly request to ESMA to standardize the process of entering into an agreement with the manufacture for the purposes of obtaining the information needed for defining the target market. The standardization would make this process smoother and simpler and it would avoid creating a new burden for the distributors/manufacturers.

- **Request for quotes situation**: Product governance provisions should not apply when an investment firm receives a request for quote from a customer. In these cases, the investment firm does not approach the client, conversely the initiative results exclusively from the client; thus this kind of activity requires great speed of response in a competitive tender situation, and firms may not have time to meet the whole process with the negative economic impact that this might entail. In addition, it should be noted that MIFID 2 (art. 42) and MIFIR (art. 46.5) recognize a special treatment for third country entities (i.e. it reduces the formal requirements for these entities to provide an investment service to clients in the European Union) when the initiative in the provision of the investment service/activity is exclusively arising from the client. This evidences that the legislator considers that these situations require a less protective treatment. Furthermore, this could give rise to a competitive disadvantage as clients could decide to request quotes to non EU entities instead as they are faster to respond.

- **Definition of manufacturer:** Clarification in respect of the definition of "manufacturer" would be appreciated. We are especially concerned about the following two situations where it could be considered that there are two co-manufacturers:

  - When an investment firms advices corporate issuers on the launch of a new product;
  - When an investment firm acts as the arranger in respect of an issuance of a special purpose vehicle.

  It is extremely important to have a clear approach in this respect and to confirm if such approach should be extrapolated to the obligations imposed by the Regulation (EU) No. 1286/2014 of the European Parliament and of the Council on key information

documents for packaged retail and insurance-based investment products as it would have an impact on the preparation of the key information documents (i.e. who should prepare the KID?; there is a section in the KID titled "What happens if [the name of the PRIIP manufacturer] is unable to pay out?", that could vary depending on who is considered to be the PRIIP manufacturer, etc,).

- **Bespoke products:** Regarding bespoke or tailor-made products, the draft guidelines state that the target market of the product will usually be the client who ordered the product unless the distribution of the product to other clients is also foreseen. We believe that, in the case of bespoke/tailor-made products addressed to the particular client who ordered the product, no product governance requirements should apply as it would only constitute an administrative burden for the investment firm and would not enhance in any way the level of protection of the client.

- In relation to the examples provided in Annex 4:
  They do not distinguish between the target market of the manufacturer and the one developed by the distributor. Clarification on this point is especially important taking into consideration the comments made by the ECON Member M. Ferber (the European Parliament's Rapporteur for MIFID 2) in relation to the Commission Delegated Directive of 7 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any non-monetary benefits. In particular, in relation to the product governance requirements, Mr. Ferber stated: "*Level 1 is quite clear that the issuer of a product defines the target market and the distributor takes it into consideration. The delegated directive however goes beyond that implying an additional target market definition made by the distributor. The Commission should clarify if this is really meant by the delegated directive and if so what would be the justification for such a 2nd target market*". From the draft guidelines, however, it could be interpreted that two different target markets would need to be identified.

  In case study 1, the part related to client objectives and client needs contains a mere description of the product which will be included in the pre-trade information that the distributor will provide to the client in accordance with Article 24 of MIFID 2 (and level 2 rules completing such provision). Therefore, in practice, it does not provide further information or a greater level of protection to the client, but constitutes a formal obligation for the firm which results in an administrative burden.

  In case study 2, in the part related to distribution channel, it is specified that where clients are classified as professional clients or eligible counterparties for this type of

business, they may be assumed to have the relevant knowledge and experience to make their own investment decisions. This is expressly stipulated in the Level 2 rules; therefore, we see no point in including it as it merely results in an administrative burden for investment firms without providing additional and valuable information or enhancing the level of protection to clients.

Investment firms should not only comply with the target market provisions, but need to be in a position to evidence that they have complied. Considering some of the examples proposed and the detail of information included (for instance, requiring the "*understanding of what factors drive the movement of share prices and of how the movement of share prices impacts the value of the product*", "*understanding of the possibility of inflation eroding value if the stock market falls over the investment term*", etc.), this may entail that the firm may have to obtain additional information/prepare particular surveys per each product. This approach: **(a)** may lead to the confusion of clients, who may believe that the firm is obtaining such information in order to provide them investment advice; what subsequently would give rise to a significant risk for firms regarding potential litigation; and **(b)** such level of detail is impracticable as firms will not be able to systematize so much information (i.e. as it would imply that firms should complete millions of data/assessments).

- Regarding examples, we propose another one regarding investment funds:

  Non complex UCITS: Product: European equity Fund

  Target Market

  - Type of client: any type of client
  - Knowledge and experience: no prior knowledge and/or experience needed.
  - Financial situation with a focus on the ability to bear losses: Potential losses limited up to the whole investment.
  - Risk tolerance: UCITS KIID indicator level 5
  - Recommended time horizon: 5 years

- Provided that the PRIIPs Regulation also requests manufacturers to include in the Key Information Document ('KID') a description of the type of retail investor to whom the PRIIP is intended to be marketed, we believe that ESMA should provide specific guidance on how PRIIPs' manufacturers are to incorporate the target market within the KID.

We believe that, for the sake of regulatory convergence and with the purpose of ensuring the harmonization of the different regulations on investor protection, the concept of target market under the PRIIPs KID and MiFID II Pre-trade information documents should be homogeneous. It would not make sense for firms manufacturing

products under the scope of the PRIIPs Regulation to draw up a target market in compliance with MiFID II product governance requirements, and then rewrite the target market for their inclusion in the PRIIPs' KID. It will place unnecessary and unjustified administrative and operative burden on firms without providing any additional benefit to consumers.

ESMA should acknowledge that the KID shall be drawn up as a short document written in a concise manner and of a maximum of three sides of A4-sized paper, which comprises seven different sections, whereas the Target Market represents only one out of five sub-sections to be included in the section 'What is this product?'. Consequently, we believe that it is unworkable to include in the KID such detailed and bespoke target market definitions as those proposed by ESMA in the Case study 1 and Case study 2 that are described in Section 4 – Annex 4 of the Consultation Paper (Illustrative examples and case studies related to the application of certain aspects of the guidelines). Case study 1 refers to a structured investment product, whereas Case study 2 describes the target market for a structured deposit product. The two products are within the PRIIPs Regulation scope, and, in both cases, ESMA proposes to draw up a target market with such detailed information that they extend over more than one page long. We believe that it would be disproportionate to require PRIIPs manufacturers drawing up the target market for the KID with such level of detail, because the KID would be left without enough space to include the rest of key information that it needs to contain.

In summary, we are very concerned with the adaptation of the target market proposed by ESMA to the PRIIPs' KID, as it would impede firms from complying with the PRIIPs Regulation. Hence, we believe that specific guidance on how to fit the target market within the KID is of utmost importance, in order to avoid creating regulatory uncertainty among market participants.

Q9: What level of resources (financial and other) would be required to implement and comply with the Guidelines (market researches, organizational, 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 organization and the nature, scale and complexity of the activities of your institution, where relevant.

In order not to raise the cost of complying with the Guidelines at disproportionate levels, it is necessary that the content of them be clearly defined and delimited, as far as possible, according to the most standardized criteria possible. On the contrary, there is a risk that categories will be defined differently by originators and distributors and that this would mean that neither the comparability of the financial instruments nor the distributors would receive homogenized information.

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ANNEX I

DEFINITION OF THE TARGET MARKET IN PRIIPs and MIFID II
Proposal from Spanish Industry

INTRODUCTION

The Spanish Banking Industry welcomes the regulators' intention to establish standards to regulate product governance and, in particular, the definition of the target market, by manufacturers and distributors. It is convinced that this will benefit the sector by making it more robust, and more trustworthy for society as a whole.

Nevertheless, we believe that it is essential to distinguish clearly between the different roles of the main actors (manufacturers and distributors) in order to assign them only those responsibilities that correspond to them, and to avoid a rise in litigation over products, which would not benefit any of the interested parties, including customers and supervisors.

It would be of particular concern if, when determining whether a given customer is part of the target market, a distributor had to obtain information about aspects (ability to bear losses, time horizon, etc.) that it could only know if it was providing an investment advice service. This could give rise to a breach of level 1 of the regulation, a risk for the distributor and misleading for customers.

In short, in our judgement, the identification of the target market for each instrument must necessarily be generic and the distributor's checking of whether the end customer is compliant or not will hinge on the distributor's role, depending on the investment service provided.

Hence, we present below a proposal on:

- The generic target market to be defined by a manufacturer
- Development of the target market to be defined by the distributor (on the basis of the generic target market provided by the manufacturer), depending on the investment service provided to the customer.
    - In execution only or intermediation
    - In services where appropriate test applies
    - In investment advice

Additionally, in the interests of legal security, it should be clarified that revisions of the target market do not affect transactions already closed.

1.- DEFINITION OF THE TARGET MARKET TO BE MADE BY MANUFACTURERS

In accordance with the proposal of the Delegated Directive, manufacturers should specify the potential target market, on the basis of their theoretical knowledge and prior experience, referring in general to the following criteria:

1) Customer Type	a) Retail b) Professional c) Eligible Counterparty d) All
2) Knowledge and experience[4]	a) No prior knowledge and/or experience are required b) Specific knowledge of the product or products of a similar nature and risk or experience are required
3) Ability to bear losses	a) The potential losses are limited to the amount indicated in the legal documentation[5]. b) The customer may experience losses of up to the whole of his/her investment. c) The customer may experience losses exceeding the total amount of his/her investment.
4) **Risk tolerance (*)**	a) High b) Medium c) Low
5) Recommended time horizon	a) Short term: less than 3 years b) Medium term: 3-5 years c) Long term: Over 5 years

(*) The checking of this criterion by the distributor (if required) may take account of possible differences between institutions in the internal categories for the classification of customers by their risk tolerance. Thus, for example, in some institutions, the criterion may be of "high, medium, low" tolerance, or it may be based on the SRI risk indicator for PRIIPs products, or on the Classification of Financial Instruments Order, etc. In these cases, each distributor should identify the corresponding equivalence between the manufacturer's categories and its own.

[4] It is not necessary to develop this criterion if the product is aimed exclusively at eligible counterparties or professional customers, inasmuch as the regulation allows it to be assumed that these have the necessary knowledge and experience.

[5] Example: For a product with a 90% guarantee, this amount would be 10%. A product with no guarantee would be in category b).

If this product is distributed together with others or is to be included in a portfolio with other financial products, the customer and/or his/her adviser should take the combined effect into account.

Similarly, the above criteria and their variables may not make sense, and therefore not be applicable or may differ in the case of those products intended for hedging[6], meaning that institutions should be allowed flexibility to adapt to such cases.

The need to apply all the above criteria, together with their level of detail, will depend on the circumstances and the type of financial instrument in question: the principle of proportionality must prevail in identifying the target market[7].

2.- DEFINITION OF THE TARGET MARKET TO BE MADE BY DISTRIBUTORS

2.1.- DEFINITION OF THE TARGET MARKET TO BE MADE BY THE DISTRIBUTORS IN EXECUTION ONLY OR INTERMEDIATION

In the order documentation, the institution will state that it lacks the information required to decide whether the customer's profile accords with the target market defined by the manufacturer, meaning that it is the customer's responsibility to ensure that he/she complies with the other criteria defined by the manufacturer, if any

2.2.- DEFINITION OF THE TARGET MARKET TO BE MADE BY THE DISTRIBUTORS WHEN APPROPRIATE TEST APPLIES

The institution will include in the pre-contract documentation a statement that it lacks the information required to decide on criteria 3), 4) and 5), meaning that it is the customer's responsibility to ensure that he/she complies with these criteria. The distributor will check that the customer complies with criteria 1 and 2, as this information can be obtained from the convenience assessment,

2.3.- DEFINITION OF THE TARGET MARKET TO BE MADE BY THE DISTRIBUTORS WHEN PROVIDING INVESTMENT ADVICE

The institution will check that the customer complies with all the criteria indicated by the manufacturer, as when it provides the advisory service it will have the necessary information from the suitability test.

[6] For example, the criterion of the ability to bear losses would not make sense in determining the target public for a hedging instrument, inasmuch as the potential losses that a customer might incur with this product would be offset by a lower cost of the product whose risk he/she seeks to manage.

[7] In the case of shares, the ESMA itself has stated that these are products that may be considered compatible with the retail market in general, and therefore the target market in these does not need to be defined in such detail.

3.- EXAMPLE OF DEFINITION AND CONFIRMATION OF THE TARGET MARKET:

Example of the target market for a 3-year structured deposit linked to equities, defined by the manufacturer as:

A product aimed basically at: eligible counterparties, retail customers and professionals [1.- Type of Customer] with a minimum level of knowledge or certain prior experience [2.- Knowledge and experience], [3.- It is not necessary to specify the ability to bear losses inasmuch as the capital is guaranteed] and whose risk profile is conservative, balanced or dynamic [4.- Risk tolerance]. Similarly, the investment objectives of the target customers would be linked to a short-term investment horizon [5.- Recommended time horizon], with the product being available on any distribution channel [6.- Compatibility with the distribution channel].

Example of information on the target market for a 3-year structured deposit linked to equities, explained by the distributor:

A product aimed basically at: any customer [1.- Type of Customer] with an educational level of knowledge equal or similar to a degree or with some prior experience in equities or derivative and/or structured products [2.- Knowledge and experience], [3.- it is not necessary to specify the ability to bear losses inasmuch as the capital is guaranteed] and whose risk profile is at least conservative[8] [4.- Risk tolerance]. Similarly, the investment objectives of the target customers would be linked to a short-term investment horizon[9] [5.- Recommended time horizon]. [6.- It is not necessary to mention compatibility with the distribution channel as there are no restrictions thereon].

Inasmuch as the institution does not distribute this product within an investment advice service, [Institution] and cannot check if the customer complies with criteria numbers 3 (irrelevant in this case), 4 and 5, it would warn him/her immediately after the description of the target customer group:

[Institution] warns the customer that it is only assessing the suitability of the product, and therefore cannot confirm: (i) whether the customer's risk profile corresponds to that defined by the manufacturer of the product for the target customer group, and (ii) whether the customer's investment time horizon corresponds to that defined by the manufacturer of the product for the target customer group.

Hence, the customer must judge for him/herself whether he/she meets these criteria.

[8] If the distributor sells the product on the basis of investment advice, it could also adapt or develop this terminology to its internal customer classification criteria, e.g. low, medium or high risk tolerance.

[9] If the distributor sells the product on the basis of investment advice, it could also adapt this terminology to the parameters used in its suitability assessment: e.g. specify that the time horizon is 3 years.