European Securities & Markets Authority
Submitted online

4 January 2017

Dear Sir/Madam,

AIMA/MFA response to ESMA's Consultation Paper,
"Draft guidelines on MiFID II product governance requirements"

The Alternative Investment Management Association[1] ("AIMA") and Managed Funds Association ("MFA")[2] (collectively: "the Associations"; "we") welcome the opportunity to provide comments to the European Securities & Markets Authority ("ESMA") on its Consultation Paper[3] on draft guidelines on MiFID II product governance requirements (the "Consultation Paper").

Many of our member firms will have to comply with the product governance requirements where, for example, MiFID-authorised firms are involved in the design and structure and/or distribution of MiFID products, including hedge funds. The target market for such products will primarily be institutional investors.

Overall, the Associations welcome ESMA's approach of providing additional guidance to clarify the application of key aspects of Directive 2014/65/EU on markets in financial instruments (MiFID II) to support consistency in implementation and supervision of the new rules. ESMA's draft guidelines seek to ensure the common, uniform and consistent application of product governance framework established in Articles 16(3) and 24(2) of MiFID II, although the guidance mainly addresses the 'target market assessment'. In our view, the current draft guidance is predominately focused on the retail market, and it would be helpful for ESMA to include a statement confirming this.

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[1] AIMA, the Alternative Investment Management Association, is the global representative of the alternative investment industry, with more than 1,700 corporate members in over 50 countries. AIMA works closely with its members to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes, and sound practice guides. Providing an extensive global network for its members, AIMA's primary membership is drawn from the alternative investment industry whose managers pursue a wide range of sophisticated asset management strategies. AIMA's manager members collectively manage more than $1.5 trillion in assets.

[2] The Managed Funds Association (MFA) represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, the Americas, Australia and many other regions where MFA members are market participants.

[3] See https://www.esma.europa.eu/sites/default/files/library/2016-1436_cp_guidelines_on_product_governance.pdf.

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Otherwise, to the extent that the guidance extends beyond retail clients, we have suggested in our submission how the rules might be proportionately applied at the sophisticated end of the market. In these circumstances, our members are of the view that it would be helpful for ESMA to provide a clear statement on how the rules would apply, on a sliding scale, depending on the nature of the product, the client type(s) targeted (and the distribution strategy).

In the Associations' view, the text of the Delegated Directive clearly contemplates a proportionate approach. The Associations believe that while regulated firms may easily apply the draft guidance to a vanilla product sold to a retail client, the guidance has limited flexibility and scalability in practical application to the wide variety of products and client types in the market. The Associations respectfully ask ESMA to clarify in a clear statement in the guidance that it expects firms to apply the rules proportionately, thereby ensuring that firms will use regulatory resources appropriately to those who will benefit from the investor protection measures. Such additional clarity will help enable firms to streamline and tailor regulatory processes at the more sophisticated end of the market. Institutional investors in particular are likely to have a more sophisticated understanding of the products (when compared with retail investors) and their own requirements and objectives, and will have performed their own due diligence on the fund and the fund manager; accordingly, it would make sense for the product governance framework to be applied proportionately in situations involving institutional investors.

AIMA and MFA members would like ESMA to confirm their view that regulators do not believe that this guidance applies to firms when providing discretionary portfolio management, such as in a client's separate account. Our members are firmly of the view that the provision of a segregated mandate is an entirely separate bespoke MiFID *service*, through which investment decisions are made solely at the discretion of the manager, based on the individual terms of an agreed investment mandate. We have addressed this point more thoroughly in our submission and look to ESMA to clarify its position in the guidance.

We hope you find our comments useful and would be more than happy to answer any questions you may have in relation to this letter. Please do not hesitate to contact Jennifer Han (jhan@managedfunds.org) and Adele Rentsch (arentsch@aima.org) in relation to the issues raised in this letter.

Yours truly,

/s/ Stuart J. Kaswell	/s/ Jiří Król
Stuart J. Kaswell Executive Vice President, Managing Director & General Counsel MFA	Jiří Król Deputy Chief Executive Officer Global Head of Government Affairs AIMA

Annex 1

Q1: 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.

The Associations are of the view that there is a considerable gap in the guidance with respect to addressing the proportionate application of the target market assessment when firms are dealing with professional clients. The overall focus of the approach appears to be on the retail market, making it difficult for firms to understand the application of the framework in the institutional space. In order to achieve an overall consistent approach, we believe it would be appropriate for ESMA to provide clarity on aspects of the target market assessment that may not be relevant, for example, in relation to specific client types.

The language of the Delegated Directive confirms that this is not a one-size-fits-all regime (see recital 18 and Articles 9(1) and 10(1)). While the guidance as currently drafted can be easily applied in relation to a fairly vanilla product targeted at retail clients, we are concerned that the guidance is lacking clarity and flexibility on how the principal requirements can be scaled up or down to be sensibly applied to the vast range of products, client types and distribution networks of varying scales and complexity. We are of the view that, if the guidance is intended to be applied beyond the retail market, ESMA will need to adapt the approach to ensure the framework can be applied proportionately. At the top end of the scale, our members are generally designing funds for institutional investors, for example, pension funds, which are regarded as having a high level of experience, knowledge and expertise in making investment decisions; understand their own needs and objectives in investing; and perform due diligence on the funds and fund managers they invest with. In these circumstances, the investor protection benefits of conducting a target market assessment appear considerably less relevant and, in our view, the MiFID firm should be able to make certain assumptions regarding certain client types and redirect their attention to products where the investor protection measures are relevant. This is especially relevant where features of the product are in line with that expected for an institutional client base – e.g. high investment minimums and tailored fee structures. It would also apply where the application process specifically requires an investor to meet certain standards (e.g. accredited or qualified investors).

Whilst we appreciate that ESMA has included a section in the draft guidelines on “application of the target market requirements to firms dealing in wholesale markets”, we do not consider that this section effectively addresses the distinction in how the list of categories should be applied to professional, rather than retail, clients. Although ESMA notes that “when assessing the appropriate target market for a particular product, firms should consider the appropriate client category and whether it allows them to make any assumptions about the end clients’ knowledge and experience”, the draft guidelines do not mention the impact of a professional client categorisation on the other issues required to be considered when identifying target markets (listed at V.II). For example, the professional client categorisation would affect not only a client’s “knowledge and experience” (category b), but likely also its “financial situation” (category c), “risk tolerance” (category d) and the client’s needs and objectives (categories e and f). We would suggest that certain assumptions could also be made in relation to these other categories (e.g. a higher risk tolerance); see further our response to Q7.

Finally, the Associations believe that the guidelines on MiFID II product governance requirements should not apply to products or funds established by a MiFID firm solely for sale to overseas investors. For example, it is often the case that a MiFID firm will register as an investment adviser with the U.S. Securities and Exchange Commission, and form a fund, pursuant to the U.S. Investment Company Act of 1940 ("1940 Act"), targeted at, and solely for sale to, US retail investors. In such instance, the sole nexus to the EU is that the investment manager firm is domiciled in the EU, and may be a MiFID firm due to other EU activities or products. We question the justification for applying EU investor protection rules in these circumstances, where local investor protection rules will apply for those investors and may be very stringent, such as the 1940 Act or the U.S. Employee Retirement Income Security Act of 1974 ("ERISA").

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

The Associations do not agree that the product governance regime should apply to bespoke or tailor-made products, developed according to the specifications of a client order. In our view, the language of the Level 1 legislation suggests the regime is designed to apply to products designed and sold to more than one client, to ensure that the manufacturer(s) and distributor(s) appropriately ensure the products are aligned with the needs of a class or classes of investors. Furthermore, in the cases of bespoke or tailor-made products, the suitability and appropriateness provisions would apply to address investor protection concerns and in our view, we see no benefit in applying a further layer of regulatory requirements to conduct a target market assessment where the product is specifically developed to the client's specifications. In this regard, we suggest ESMA revise the proposed approach and clarify that truly bespoke or tailor-made products should not be subject to a target market assessment. For example, if a fund trading a certain strategy is created on request from a client (via an RFP process or reverse enquiry) and is dedicated to one client only then the need to apply a target market assessment would be eliminated. Paragraph 20 of the draft guidelines, which notes that the "target market" for "bespoke or tailor-made" products" would "usually be the client who ordered the product" should therefore be deleted, given that it implies that a target market assessment relating to knowledge and experience, ability to bear risk etc. would need to be made in relation to that one client (despite the client having already been subject to suitability and appropriateness assessments).

In our view, if a product is developed in negotiation with a sophisticated institutional investor, as opposed to being structured and designed for sale to a class or classes of investors, it is inherent in the process itself that the product is fit of purpose and the concerns that the investor does not understand the product are not relevant. For example, where a professional investor (e.g. sovereign wealth fund or large pension fund) has requested/negotiated a share class in a commingled fund denominated in a particular currency and with a specific fee deal and the share class has been specifically set up for that investor. As the sole investor in this share class has requested the creation of this share class with the investment manager, or because the terms have been specifically negotiated, the application of proportionality should mean that there should be no need to run through the target market tests, simply by virtue of the fact that the product has been set up specifically for a wholesale investor. A similar approach can be taken to the same set of facts being applied to set up of a fund for one client (fund of one) based on their needs and requirements and for their sole investment purposes.

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

The concerns raised earlier in this submission regarding the limitations on the practical application and scalability of the guidance are also relevant to the guidance for distributors. In practice, we expect that the level of granularity a manufacturer is able to go into in their target market assessment will generally be correlated to the size of their distribution network; the larger the distribution network, the more reliance a manufacturer is likely to place on the distributor to identify the target market.

AIMA and MFA members are generally more likely to market their funds themselves, and will therefore conduct a single target market assessment, with the target market more likely to be readily identifiable. One common exception will be in relation to the sale of UCITS funds, where they are more likely to sell through third-party distributors, for example through professional adviser platforms. In those circumstances, our members will place a higher reliance on the distributors they are facing off to, and adapt their own target market assessment accordingly.

Member firms forming part of a group may also rely on an entity within the group to market funds to investors. In this situation, firms would be in a position to closely collaborate on identifying the target market and would see little benefit in the need to duplicate the assessment. Our members would welcome clarification of this point, and encourage ESMA to take a practical approach to proportionality with respect to such intra-group arrangements.

Overall, it would be useful for ESMA to revise the guidance to ensure there is consistency in firms' approach and regulators' expectations on the sliding scale of proportionality depending on the target market, the nature of the product and the distribution strategy. It would also be helpful to understand the regulators' expectations on the sharing and assimilation into target market assessments of information shared between manufacturers and distributors, particularly in the context of more extensive distribution networks.

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.

The Associations welcome ESMA's approach in recognising that products may form a small part of an investor's portfolio from a diversification point of view. However, in our view, paragraph 33 of the draft guidance seems overly broad, in that diversification requirements have been recognised as needed but how these then need to be reported to the manufacturer for governance requirements is left opaque and seems unnecessarily burdensome, with no clear rationale for the extra reporting requirement. We encourage ESMA to provide industry with additional clarification in the final guidance on the type of information expected to be reported by the distributor, and how this information is expected to be used by manufacturers to feed into their target market assessment.

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

This is likely to be less relevant for AIMA and MFA members, which tend to market their funds themselves

or distribute through third-party distributors. They are unlikely to act as third-party distributors of other funds. Additional guidance will, however, be relevant to the extent that it impacts member firms distributing funds through MiFID distributors. In this regard, while it will be helpful for firms to understand the extent of their information-sharing obligations, we encourage ESMA to avoid creating an overly burdensome regime for distributors in these circumstances, and restrict the impacts on non-MiFID manufacturers.

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

In our view, it would seem that if the 'target market' is identified correctly then this would fully mitigate the need to have a 'negative' target market and the positive identification alone would be sufficient. We note in this respect ESMA's statement at paragraph 19 of the draft guidelines that "in all cases, the target market must be identified at a sufficiently granular level to avoid the inclusion of any groups of investors for whose needs, characteristics and objectives the product is not compatible". This level of granularity would appear to obviate the need for a negative target market assessment.

Particularly in the institutional space, we do not see the benefit of an assessment of the negative target market. If an investor does not align with the positive target market, then it would follow that the product was not targeted to that investor. A subsequent suitability and appropriateness assessment may determine that the product is suitable. However, in the institutional space, it appears to us more relevant to more specifically identify whether certain features of a product would not be suitable for a certain type of investor; however, this is likely to be clear from the positive compatibility assessment of the product features (e.g. a private markets product requiring locked up capital for an investor that had daily-monthly liquidity requirements).

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

The Associations believe it would be beneficial for industry if there were standardised client types within the MiFID II categorisations. The ESMA Consultation Paper suggests that firms may develop their own descriptions within the MiFID II categories, for example 'private wealth clients' or 'sophisticated clients'. We believe that it would be worthwhile for the regulators to standardise the approach to common client types (noting this should not be exhaustive to allow for some flexibility) to ensure a level of consistency.

In our view, there are a number of types of per se professional clients in relation to whom firms should be able to assume a detailed understanding of their own investment requirements and objectives, and that they will have performed their own due diligence on the fund and the fund manager. Unless it becomes apparent there are reasons that the investor is not properly advised, we believe client types of this nature should be subject to a proportionate approach under the regime. This will be relevant for a number of institutional investors, including for example, pension funds (and their management companies), sovereign wealth funds and national government bodies. Similarly, where a fund manager is selling interests in a fund to a regulated professional adviser or a regulated financial institution, such as a private bank acting as principal, conducting a target market assessment is likely to be duplicative and of little, if any, benefit.

There may also be other client types in the retail space where it may be appropriate for firms to also take a proportionate approach to conducting a target market assessment, for example, in relation to self-certified sophisticated investors and high net worth individuals. In this regard, the FCA currently exempts (at COBS 4.12 of the FCA Handbook) such persons from a restriction on the financial promotion of non-mainstream pooled investments; however, such persons will remain sufficiently protected by a suitability assessment.

It would be useful for ESMA to consider incorporating a standardised approach to common client types, and provide clarity on how the rules should apply proportionately in the context of different client types.

As a general comment based on the current drafting of the guidelines, however, the Associations disagree with the distinction made at paragraphs 72-73 of the Consultation Paper between "per se" and elective professional clients (i.e. that firms should necessarily assume a lesser degree of knowledge in relation to elective professional clients). Although Annex II to MiFID II notes generally that elective professional clients should not be "presumed to possess market knowledge and experience" comparable to per se professional clients, it goes on to state that such clients may nevertheless waive protections that would otherwise apply where the investment firm in question has undertaken "an adequate assessment of the expertise, experience and knowledge of the client", which "gives reasonable assurance, in light of the nature of the transactions or services envisaged, that the client is capable of making investment decisions and understanding the risks involved". Firms conducting a target market assessment for the purposes of the product governance regime should not be required to reconsider the knowledge and expertise of elective professionals, but should instead be able to rely on the assessment already conducted in relation to the client's categorisation and treat the entity as they would any other professional client (particularly given that no distinction would be made between the two types of client in applying the majority of other MiFID II requirements). In addition, ESMA should bear in mind that categorisation as an elective professional client will not necessarily extend to all types of products and services, but is instead targeted at the client's knowledge in a particular field (which may be highly relevant to the product being assessed for the purposes of the product governance regime). As a general matter, ESMA should not require firms seeking to apply the product governance rules to repeat assessments of knowledge and competence that may already have been undertaken pursuant to client classification or suitability assessments.

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

AIMA and MFA members have noted the various references to portfolio management activity within the ESMA draft guidelines on MiFID II product governance requirements and are concerned to ensure that there is no expectation that the provision of discretionary portfolio management is intended to be caught under this guidance.

Portfolio management activity is defined in the MiFID II text as "managing portfolios in accordance with mandates given by clients on a discretionary client-by-client basis where such portfolios include one or more financial instruments." We think this definition clearly puts portfolio management outside the scope of the provisions of the MiFID II texts relating to "products" and "product governance" for the following reasons:

(i) Portfolio management envisages a mandate "given" by a client – meaning that it is the client

who decides how their portfolio should be constructed rather than the creation of a "product" for sale across a potential spectrum of investors. This certainly reflects the reality of portfolio management activity within the institutional space where clients have very clear ideas about what type of portfolio they want and for which reasons (this could be for hedging purposes, liability matching purposes, pure investment purposes or a variety of other reasons all of which reflect the requirements on a case by case basis);

(ii) Portfolio management envisages "discretionary activity". This means that the manager will be choosing underlying investments in its discretion according to the mandate given. It is the manager and not the underlying client who will be making decisions on underlying investment. In this situation it is the discretionary portfolio manager which is the target market, not the portfolio manager's underlying client. This reflects the practice under AIFMD for example where a sale of an AIF to a discretionary manager is deemed to be a sale to a professional client regardless of whether the portfolio manager is managing a portfolio for a professional or retail client;

(iii) Portfolio management envisages activity on a "case by case basis". We think the concept of "product" is more designed to cover financial instruments or products which may be sold on a mass or at least on a duplicated basis and not within a service which is clearly understood to relate to a single identifiable client on a "client by client basis"; and

(iv) Portfolio management relates to discretionary management in respect of portfolios which include one or more financial instruments. ESMAs guidance states that the "objective of the product governance requirements is to ensure that firms, which manufacture and distribute financial instruments and structured deposits, act in the clients' best interests during all the stages of the life-cycle of products or services." A discretionary portfolio may include financial instruments but those instruments will on the whole be manufactured or distributed by third parties. To the extent that a portfolio includes financial instruments which are manufactured or distributed by the portfolio manager itself then clearly those instruments will be caught by product governance requirements but not in other circumstances (and for the purposes of assessing target market this would include discretionary portfolio managers and not underlying clients of discretionary managers).

Accordingly, we are of the view that a segregated mandate is not a product; it is an investment service. In the event that it is considered a product, this would appear to result in a wholly undesirable and unintended outcome where the concept of a product incorporates both financial instruments and investment services/activities (including portfolio management and investment advice, etc), which are distinctly defined under MiFID II. In our opinion, discretionary portfolio managers are also not acting as a distributors of the underlying instruments invested in on behalf of the client, for the reasons outlined above.

We note that the absence of product governance in relation to discretionary portfolio management does not mean that there is a gap in the protection given to clients. This will be well covered under the suitability and appropriateness assessment pursuant to Article 25 of MiFID II. Given the possibility for a misunderstanding or divergence of interpretation by national regulators, advisers and the industry as a whole, we ask ESMA to clarify MiFID II product governance requirements do not cover discretionary investment management.

Q9: What level of resources (financial and other) would be required to implement and comply with the Guidelines (market researches, organisational, IT costs, training costs, staff costs, etc., differentiated between one off and ongoing costs)? If possible please specify the respective costs/resources separately for the assessment of suitability and related policies and procedures, the implementation of a diversity policy and the guidelines regarding induction and training. When answering this question, please also provide information about the size, internal organisation and the nature, scale and complexity of the activities of your institution, where relevant.

The Associations are not in a position to respond at this time.