

AMF Position

Fund performance swaps and actively managed investment structures – DOC-2008-14

Background regulations: Articles L. 214-20, L. 214-24-55, R. 214-19 II and R. 214-32-28 II of the Monetary and Financial Code

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The present Position concerns UCITS, retail investment funds, private equity funds, funds of alternative funds, professional investment funds, professional specialised investment funds, professional private equity investment funds and employee investment undertakings (i.e. collective investment schemes, CIS).

Fund performance swaps are financial contracts that enable a “master” CIS to receive the performance of one or several underlying or target funds.

Naturally, CIS using such financial contracts have to respect the applicable prudential rules and professional ethics¹. They are also required to maintain an adequate level of protection for unit holders/shareholders.

More specifically, Articles 411-107 and 422-68 of the AMF General Regulation state that key investor information documents should “*contain accurate, clear, non-misleading information*”. Moreover, Articles 411-113 and 422-71 of the AMF General Regulation stipulate that the CIS prospectus “*shall include the information necessary for investors to make an informed judgement of the investment proposed to them*”. In accordance with Instructions 2011-19 and 2011-20, the conditions in which a CIS may have recourse to this type of financial instrument have to be described in its prospectus.

¹ As explained in Articles D 214-0 *et seq.* of the Monetary and Financial Code.

These swaps are intended to achieve the following:

- either to offer investors indexation on a basket of underlying funds, often coupled with full or partial capital protection, in the context of formula funds, for example. These are usually fund performance swaps with an option component;
- or to offer unit holders, particularly under discretionary management regimes, the benefit of the expertise of particular asset managers specialised in specific fields or the possibility of accessing funds to which they could not subscribe directly by reason of an excessively high initial subscription amount, for example. These are usually fund performance swaps without an option component (so-called 'delta one' products).

Actively managed investment structures include CIS based on baskets of assets (equities, UCITS/alternative investment funds, etc.) whose composition is managed actively or regularly altered in a more or less discretionary manner. In contrast, passively managed investment structures include CIS based on baskets of assets that do not change or are defined according to predetermined rules.

In the light of the difficulties raised by performance swaps, particularly in relation to investor information, conflicts of interest and valuation, and as several asset managers are offering investment structures based on actively managed products, the AMF has decided to update and publicise its doctrine in this field. Establishing a level playing field between CIS and structured EMTN- or certificate-type products is an important consideration. Part of the AMF's task is identifying the conditions in which investment structures using actively managed products could be eligible for CIS.

The present Position is intended to describe the factors requiring particular attention when a CIS has recourse to fund performance swaps or investment structures based on actively managed products².

1. The main characteristics of fund performance swaps

1.1. Investment and eligibility rules

As financial contracts concluded outside regulated futures markets, fund performance swaps have to be concluded between credit institutions or investment firms in accordance with Articles L. 214-20 and L. 214-24-55, and as mentioned in the second paragraph II of Articles R. 214-19 and R. 214-32-28 of the Monetary and Financial Code. Moreover, recourse to these instruments is subject to the counterparty risk limit defined in paragraph 5 of Article R. 214-21 and in Article R. 214-32-29 of the Monetary and Financial Code as well as the global risk constraints described in Articles R. 214-30 and R. 214-32-41, for example, of the same Code³.

The funds underlying the swap contract must meet eligibility and asset composition rules in accordance with the transparency principle described in Articles R. 214-15-1 and R. 214-32-24 of the Monetary and Financial Code. This means that swaps cannot in any circumstances permit a CIS to receive performance from a fund that it would be unable to invest in directly. Similarly, these financial contracts cannot be used to enable a CIS to bypass asset composition rules. Thus a CIS exposing 100% of its assets to risks of other funds via a swap contract has to comply with the risk segmentation ratios applicable to CIS that invest in units or shares of UCITS or funds of alternative funds under French or foreign law or investment funds in third countries⁴.

² All of the regulations concerning UCITS, retail investment funds, private equity funds, funds of alternative funds, professional investment funds, professional private equity investment funds, employee investment undertakings and investment management companies are applicable. Professional specialised investment funds are not concerned by the entirety of the recommendations in this Position, as by their very nature they are not subject to authorisation or certain regulatory provisions.

³ Generally speaking, the global risk limit is determined by Articles R. 214-30 and R. 214-32-41 of the Monetary and Financial Code and by Articles R. 214-193 for professional investment funds. The global risk calculation method is explained in Articles 411-71-1 to 411-81 and Articles 422-50 to 422-60 of the AMF General Regulation and highlighted in Instruction 2011-15.

⁴ These ratios are defined in Articles R. 214-25, R. 214-32-42, R. 214-32-33 and R. 214-32-35, and depend on the legal status of the fund of funds in question.

Apart from the regulations mentioned above, the transparency principle applies irrespective of the specific investment rules (e.g. the nature of underlying funds, exposure limits to funds) that may feature in the master CIS prospectus.

1.2. The best execution principle

In accordance with the best execution principle, by virtue of which investment management firms obtain the best possible performance for their clients⁵, the firm managing the master CIS has to be in a position to benefit from the best possible terms for the target funds selected. It follows that if the target funds have several unit categories, the units in the underlying funds selected for the swap have to be those with the lowest fees and expenses, as would be the case if the master CIS invested directly in the target funds. Similarly, it would not be appropriate for a master CIS to conclude a swap agreement with distributing funds unless the performance received included capitalised coupons or, where possible, coupons are paid to the master CIS. And when the performance swap counterparty benefits from management fee rebates from the underlying funds, the investment firm managing the master CIS must ensure that these rebates are taken into account in the cost of the performance swap and that the arrangement is not intended to sidestep rules on retrocessions.

1.3. Valuation

In accordance with Article L. 533-10-1 of the Monetary and Financial Code, the master CIS must put in place “*a permanent process for the accurate and independent assessment of the positions and operations of the portfolio being managed, and notably the value of OTC financial contracts*”.

Fund performance swaps are far more complicated to value than other complex derivatives, as the underlying assets are not nearly as liquid as traditional financial assets and their performance is not always comparable with or evident from market data available for traditional asset classes. This means that the valuation frequency for the target funds has to be consistent with that for the master CIS, and it has to be possible to model the target funds’ behaviour in a reliable manner (using simulations, for example). The investment firm managing the master CIS therefore has to pay particular attention to the valuation methods used (models and market parameters).

2. Independence of the investment management company and preventing conflicts of interest

In accordance with Articles L. 214-9 and L. 214-24-44 of the Monetary and Financial Code, the performance swap counterparty’s status must not compromise in any way the independent management of the master UCITS or fund of alternative funds or target funds.

Furthermore, Article L. 533-10 of the Monetary and Financial Code⁶ and Articles 313-20 and 318-15 of the AMF General Regulation stipulate that as investment service providers, management firms “*shall establish and maintain an effective conflicts of interest policy*”.

⁵ cf. Article L. 533-18 of the Monetary and Financial Code.

⁶ “*Investment services providers shall... 3. Take all reasonable steps to prevent conflicts of interest damaging the interests of their clients. Such conflicts of interest are those between, on the one hand, the service providers themselves, persons under their authority or acting on their own account, or any other person directly or indirectly related to them by a controlling relationship, and on the other hand, their clients; or between two clients during the provision of any investment service or any related service or a combination of such services. When these steps are not enough to guarantee with reasonable certainty that the risk of damage to clients’ interests will be avoided, the service provider shall clearly inform them of the general nature or the source of these conflicts of interest before taking any action on their behalf.*”

2.1. At master CIS level

The investment firm managing the master CIS has to carry out its own due diligence in selecting the target funds, and there should be no clause in the swap contract that authorises an intermediary to interfere during the contract's life in the investment and divestment choices made by the CIS, i.e. in the selection of target funds. Note that for its own coverage needs, the counterparty may require certain conditions concerning the target funds to be met before concluding the swap with the master CIS (historical minimum net asset value, sufficiently high outstandings or limited share of outstandings, low volatility etc.) and can therefore be authorised to adjust the underlying funds on which the performance swap is based.

Any due diligence carried out by the swap counterparty does not exempt the investment management company from its own due diligence requirement. Nor would it alter the management company's responsibility for selecting the underlying funds. More specifically, the management company must ensure that the contractual obligations and constraints defined *ab initio* with the swap counterparty are compatible with the master CIS management objective and risk profile.

2.2. At underlying fund level

In order to limit the potential impact of the swap counterparty on the target fund's management and performance, particular attention has to be paid to the way the master CIS is structured. Two specific factors should be examined:

- the maximum share of the master CIS in outstandings of each of the target funds (via the swap counterparty), taking account of changes in coverage over the life of the swap;
- the number of funds underlying the swap, especially in the case of swaps with an option element.

The counterparty's possible influence on the performance and management of the target funds is greater when the share of outstandings is high and/or the number of underlying funds is low. For example, if the share of outstandings in one of the target funds is high and the counterparty acts directly on fund units for cover purposes, it could have an influence as the main unit holder on management choices within the fund in question or could undermine its performance (via frequent and large subscriptions/redemptions) to the detriment of other unit holders.

The counterparty's influence on the performance of target funds can be reduced if it manages its coverage not by buying or selling fund units but by resorting to indices or assets that behave in the same way as the fund, for example. But this coverage method can have drawbacks: the quality of the counterparty's cover can be affected by divergence between the target funds and the assets used for cover, which in turn can lead the counterparty to interfere with management choices at the target funds or drive structuring costs higher.

Either way, and irrespective of the solution retained, it is for the firm managing the master CIS to ensure that the overall structure proposed is capable of handling all risks of conflicts of interest adequately and is not liable to undermine the independence of management at the target funds, notably via action on the part of the counterparty.⁷

3. Changes to target assets

3.1. Investment structures based on actively managed products

When a CIS is structured using a basket of actively managed assets, the selection process for the underlying must be based on criteria precise enough to allow the counterparty to anticipate asset performance correctly and thereby control risk (e.g. volatility, correlation, tracking error). This requirement helps avoid the hazards of excessive valuation and aggravated risks of conflicts of interest. In this case, the firm managing the master CIS must ensure transparency and an audit trail for the active management process as well as appropriate information to its unit holders.

⁷ Taking into account of the choice of target funds, the structure of the master CIS and the coverage method retained.

More peripherally, situations can arise in which the master CIS decides to replace one of the underlying assets with another for some reason (the desire to include an asset whose expected performance is better than that of the assets currently included in the basket, for example). Note that this type of change cannot be made without prior notification to the AMF, which will determine whether it requires authorisation (transformation) or not (alteration).

3.2. Passively-managed structured products

When a CIS is structured using an *a priori* fixed basket of underlying assets, changes to those assets are exceptional only. Clauses permitting the replacement of these assets must be precise and based on objective criteria.

If the underlying basket is made up of funds, two types of event can justify the replacement of one of its components:

- changes to the conditions related to the counterparty's access to the fund (increase in subscription/redemption fees, decline in outstandings below a certain threshold, net asset value suspended, etc.);
- changes related to the fund's management as evidenced by an amendment to the prospectus (change in management objective or investment strategy, merger etc.).

The replacement fund must be of a similar nature to the fund it is replacing (classification, management objective, investment universe, risk profile, etc.).

In order to ensure that the replacement of an asset does not make a significant difference to the value of the performance swap or the formula's profile, the firm managing the master CIS must be in a position to assess the relevance and cost of the change through appropriate due diligence on the volatility of the new underlying asset and its correlation with other assets.

4. Unit holder information

4.1. Target funds

When the CIS objective consists wholly or mainly of delivering performance from a basket of target funds, the prospectus must describe those funds and their allocation within the basket.

As far as the replacement of target funds is concerned, the full master CIS prospectus must describe the events justifying replacement, the conditions under which it can be done and the means of informing unit holders/shareholders. Note that this information must be provided to unit holders/shareholders in specific form and should describe explicitly the impact of the change on the expected return.

In all other cases⁸:

- the investment strategy in the key investor information document must describe the ranges of exposures to the underlying funds and, depending on the exposure level, the features liable to be considered in their selection (management strategies, investment universe, etc.);
- the prospectus must also explain the terms on which the master CIS can resort to these swap contracts and describe their characteristics (delta one, option component etc.).

⁸ e.g. CIS whose objective consists of using performance swaps only intermittently or more marginally.

4.2. The master fund's risk/return profile

The prospectus must not contain any ambiguity on the “optimal” or “optimised” nature of asset management. Specifically, it should explain clearly the constraints on the selection of the underlying funds. Thus when the master CIS is a formula fund indexed on a basket of funds, the advantages/disadvantages section could explain that the underlying assets are selected in the light of a strong correlation with an index, for example, and this could reduce the scope to select underlying assets that are strongly outperforming the market.

Note also that the risk profile must incorporate the specific risks related to the use of performance swaps or investment structures based on actively managed products.

4.3. Fees

As with funds of funds, the master CIS prospectus must state the maximum fee amount borne by the target funds. In the case of swaps without an option component, the fees for underlying funds must be included in the total of current fees, and where applicable with the deduction of rebates accorded to the master CIS.

5. Practical steps in establishing a CIS with recourse to a fund performance swap or to an investment structure based on active management

Prior to the first use of a performance swap on a fund with an option component, the management company must have described in its initial business programme or in an update its organisation as well as the human and technical resources dedicated to this type of swap.

The authorisation request file submitted to the AMF upon the establishment of a CIS with recourse to an **investment structure based on actively managed products** must include a technical note describing the following:

- the objective sought and the reasoning behind the selection of the target assets;
- the counterparty coverage process and the CIS structure (share of outstandings, etc.), together with any other factor showing that the risks of conflicts of interest are under control and management independence is maintained;
- the scope of active management and the means of ensuring transparency and an audit trail for this management;
- in the case of a structure based on investment funds, the nature of the target funds (classification, management objective, fees, target clientele, etc.) and any other information showing that the master CIS has sought to obtain the best terms on the underlying funds.

Concerning **investment structures based on passively-managed products**, some of the details listed above may be appended to the CIS authorisation file if the management company deems such information necessary to the consideration of the authorisation file or if the CIS in question has new features⁹.

⁹ This information may be noted in the file if the CIS is the first for the management company to have recourse to a fund performance swap, for example.