

AMF Position

Extra-financial criteria for securities selection and application of these criteria to CISs declaring themselves compliant with Islamic law – DOC-2007-19

Reference texts: Articles L. 214-9, L. 214-24-44, R. 214-22 I and R. 214-32-30 I of the Monetary and Financial Code and 313-54 and 318-1 *et seq.* of the AMF General Regulation

UCITS and CISs: 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 may use criteria other than financial ones when choosing the securities in which they invest.

In such cases, the AMF examines the applications of CISs which have filed for approval on the basis of rules that it has so far applied – in a conventional manner – both to CISs using strategies based on extra-financial criteria, such as socially responsible investing or sustainable development.

These same assessment factors also apply when authorising funds that declare themselves to be compliant with Islamic law, otherwise known as Islamic funds. These criteria are reviewed briefly below.

1. Conditions for using extra-financial criteria

When extra-financial criteria are used to select the securities in which the CIS invests, they are generally part of a broader stock-picking process that also employs standard financial criteria, such as the value of the instrument, the analysis of its upside potential and of the issuer's fundamentals. Accordingly, no specific difficulties arise provided that the extra-financial criteria do not infringe regulatory principles. In this respect, the AMF pays particular attention to the following:

- Preserving the autonomy of the asset management company (Articles L. 214-9 and L. 214-24-44 of the Monetary and Financial Code). This means, for example, that securities may not be chosen by an entity other than the company in charge of the financial management of the CIS. By contrast, a separate entity may give an opinion on the securities chosen by the asset management company, that extra-financial criteria are applied to the instruments preselected by the company.
- The involvement of a third party does not relieve the asset management company of its duty to put in place the resources needed to carry on its business (Articles 313-54 and 318-1 *et seq.* of the AMF General Regulation). This requires, for instance, that the asset management company be able to assess the extra-financial criteria it has defined.
- The selected extra-financial criteria must comply with all prevailing regulatory and statutory requirements. For example, criteria based on the race or religion of the managers of the companies invested in by the CIS cannot possibly be admitted because they violate public policy principles.
- Lastly, the CIS uses a strategy described as an index-linked or index strategy and applies the risk-spreading rules applicable to this type of scheme, the index in question must satisfy the requirements of Articles R. 214-22 I and R. 214-32-30 I of the Monetary and Financial Code regarding diversification, representativeness and security. In this case, the role of the organisation that compiles the index is taken into account when assessing the autonomy of the management company.

Moreover, it should be noted that a CIS may commit to paying directly or indirectly one or several pre-determined entities according to the procedures set forth in its regulatory documents. In such cases, it is

appropriate to refer to the AMF position 2012-15 on the criteria applicable to shared-return collective vehicles.

2. Application to CISs declaring themselves compliant with Islamic law: a case study

One practical application of the position outlined above is the case of CISs that declare themselves to be compliant with Islamic law, or Sharia.

Having recently been called upon to approve an index fund that declared itself Sharia-compliant, the AMF noted that the scheme satisfied the aforementioned criteria:

- It replicates an index published by an independent supplier and obtained by screening the components of a broad global equity index using the extra-financial investment rules described below. These rules, established by a supervisory committee composed of prominent religious figures, have been published. The fund's strategy basically consists in investing in the stocks making up the index.
- The securities selection criteria adopted by both the index supplier and the fund so as to guarantee compliance with Islamic law are objective and have been made public. They pertain to sectors of activity and apply to certain financial ratios. For example, companies that rely on the alcohol and tobacco industries or pork-related products, etc., for their business and income are excluded. Other exclusions, still by way of example, concern companies with total balance sheet debt that exceeds 33% of their average market capitalisation over the previous twelve months.
- The autonomy of the asset management company is preserved. The company appoints a supervisory committee to advise the fund manager on Sharia-related issues. When examining the authorisation request, the AMF made sure that the actions of the supervisory committee did not compromise the independence of the asset management company and that the committee confined itself to giving an ex post opinion on the securities already chosen by the manager.