



## A GUIDE TO THE MONITORING OF COLLECTIVE INVESTMENT UNDERTAKINGS

**Background regulations: Articles L. 214-3, L. 214-15, L. 214-7-4, L. 214-24-15, R. 214-15, R. 214-32-23, R. 214-15-1, R. 214-16, R. 214-22 and D.214-22-1, D. 214-5, D. 214-32-12, D. 214-32-15, D.214-32-31 of the Monetary and Financial Code, Articles 316-3, 319-13, 321-2, 321-100, 411-6, 411-10, 411-14, 411-20, 411-74, 411-75 à 411-80, 411-9, 422-7, 422-11, 422-15, 422-21, 422-53 to 422-59 of the AMF General Regulation and Article 44 (3) of Commission Regulation (EU) 2017/565 of 25 April 2016**

When monitoring collective investment undertakings, the Autorité des Marchés Financiers ensures that the operating conditions and management strategies of the undertakings comply with their regulatory documents and with the applicable legislative and regulatory provisions. This monitoring process is distinct from the controls and investigations which can be carried out by the AMF concurrently.

In this context, the document:

- recalls certain regulatory provisions applicable and indicates how they shall be interpreted;
- sets out recommendations for applying them;
- gives concrete examples of compliance and non-compliance with the regulations.

The positions and recommendations presented in this guide are in line with the policy already published or applied by the Autorité des Marchés Financiers as part of the examination of the individual approval files. This document is being updated on a regular basis.

**Except when specifically identified as recommendations, the policy elements featuring in the present guide are positions.**

It is pointed out that whenever relevant, any references to the Key Investor Information Document (KIID) must be understood in this document as including a reference to the Key Information Document in Regulation (EU) n° 1286/2014 of the European Parliament and the Council of 26 November 2014 (“PRIIPS”).

### Table of contents

1. Control procedures.....	3
1.1. Adequacy between the programme of operations and the financial instruments used.....	3
1.2. Due diligence to be conducted in the event of a merger between a UCITS and other collective investment schemes.....	4
1.3. Due diligence to be conducted for the monetization of a collective investment undertaking using portfolio insurance techniques .....	4

1.4.	<b>Due diligence to be conducted when using financial contracts the underlying of which is a real estate index</b>	5
1.5.	<b>Due diligence to be conducted when introducing gates in real estate funds, professional real estate funds, professional investment funds, and funds of alternative funds</b>	5
1.5.1.	Description in the prospectus	6
1.5.2.	The method chosen	6
1.5.3.	Procedures for triggering the gates	7
1.5.4.	Order execution	7
1.5.5.	Order cancellation	8
1.5.6.	Investor information	8
1.6.	<b>Due diligence to be conducted in the monitoring of formula funds</b>	8
2.	<b>Managing collective investment undertakings reaching maturity</b>	8
2.1.	<b>Managing the fund in the investors' interest and minimum amount of assets under management</b>	8
2.2.	<b>Executing significant redemptions orders, in particular when the collective investment undertaking is close to the regulatory threshold</b>	10
2.3.	<b>Organising liquidation</b>	11
2.4.	<b>Valuation rules</b>	12
2.5.	<b>Liquidation of ETFs (including in merger operations)</b>	12
3.	<b>Side pocket AIFs</b>	13
3.1.	<b>Must the replicated collective investment undertaking be approved by the AMF?</b>	14
3.2.	<b>Notification to the AMF: content and procedures</b>	14
3.3.	<b>Procedures for informing investors</b>	15
3.4.	<b>Which assets can be transferred to a side pocket AIF?</b>	15
3.5.	<b>What is run-off management?</b>	15
3.6.	<b>What is implied by the legal nature of the replicated and split collective investment undertakings, provided for in Articles D. 214-5, D. 214-8, D. 214-32-12 and D. 214-32-15 of the Monetary and Financial Code?</b>	16
3.7.	<b>Why do common fund demergers benefit from a specific regime?</b>	16
3.8.	<b>Are Instructions 2011-19 and 2011-20 applicable in the event of a merger decided pursuant to the second paragraph of Article L. 214-8-7 or the second paragraph of Article L. 214-24-41 of the Monetary and Financial Code?</b>	17
3.9.	<b>Does a demerger decided pursuant to Article L. 214-8-7 or Article L. 214-24-41 of the Monetary and Financial Code give investors in the split collective investment undertaking the right to exit free of charge?</b>	17
3.10.	<b>Can the replicated collective investment undertaking be marketed?</b>	17
3.11.	<b>Can past performances of the split collective investment undertaking be mentioned in the documents (prospectus, marketing materials, etc.) of the replicated collective investment undertaking?</b>	18
3.12.	<b>Can a side pocket AIF be transformed, merged or demerged?</b>	18
4.	<b>Compensation procedure</b>	18
4.1.	<b>Impact analysis</b>	18
4.2.	<b>Settlement and compensation of the prejudice suffered</b>	19

5.	Classifications, calculating exposure and overall risk .....	20
5.1.	<b>Taking into account all financial instruments when calculating exposure .....</b>	<b>20</b>
5.2.	<b>Compliance with the rules imposed by the categorisation or set out in the key investor information document (KIID) and in the prospectus .....</b>	<b>21</b>
5.3.	<b>Clarification of the definition of ancillary risk.....</b>	<b>22</b>
5.4.	<b>Calculating overall risk in the case of arbitrage strategies .....</b>	<b>22</b>
5.5.	<b>Offsetting exposure to index futures with a basket of equities as part of the commitment calculation method.....</b>	<b>23</b>
5.6.	<b>Using the VaR calculation method when measuring overall risk .....</b>	<b>23</b>
5.7.	<b>Distinction between the historical VaR and the ex post VaR .....</b>	<b>24</b>
5.8.	<b>Backtesting VaR models.....</b>	<b>24</b>
6.	Information to investors .....	25
6.1.	<b>Determining the investment objective on the basis of market assumptions made by the management company.....</b>	<b>25</b>
6.2.	<b>Consistency of certain types of UCITS transformations or of certain movements in liabilities with the information provided to investors .....</b>	<b>25</b>
6.3.	<b>Mergers and information to investors .....</b>	<b>26</b>
6.4.	<b>Informing investors about the guaranteed principal amount.....</b>	<b>27</b>
6.5.	<b>Consistency of the information provided in the key investor information document (KIID) and in the prospectus with the information disseminated in the marketing materials of the collective investment undertaking.....</b>	<b>27</b>
6.6.	<b>Marketing AIFs reserved for 20 investors .....</b>	<b>27</b>
6.7.	<b>Transformation of a fund established with a pre-determined time horizon (excluding formula funds)</b> 27	
7.	Monitoring of exchange-traded funds (ETFs) .....	29

## 1. CONTROL PROCEDURES

### 1.1. Adequacy between the programme of operations and the financial instruments used

Scope: Collective investment undertakings

Pursuant to Articles 316-3 and 321-2 of the AMF General Regulation, the asset management company approval application file shall include “a programme of operations for each of the services that [it] intends to provide, specifying the conditions in which it expects to provide those services and indicating the type of transactions envisaged and its organisational structure.” Moreover, Article 6 of Chapter II, Title 1 of Instruction 2008-03<sup>1</sup> stipulates that the programme of operations “is adapted to both the portfolios managed and the instruments used as part of the management strategy implemented by the company (...).”

---

<sup>1</sup> Instruction AMF DOC- 2008-03 - Approval procedures for asset management companies, disclosure requirements and passport.

It is the duty of the asset management company to ensure that the type of financial instruments used is consistent with the management strategies implemented on the first hand, and that its organisational structure is adapted to the means at its disposal on the other hand. Peculiar attention must be paid to the ability of the asset management company to identify the risks linked to the financial instruments used and the strategies implemented and to value these financial instruments in an independent and accurate manner. In particular, the analysis cannot possibly rely only on the legal characterisation (equities, bonds) of the securities acquired.

For instance, an asset management company whose programme of operations restricts itself to describing the procedures for using listed financial instruments and simple futures financial instruments cannot use exotic options or structured products containing derivatives (such as complex EMTN or structured certificates) when managing its collective investment undertakings if it fails to describe the means necessary to operate this activity in the programme of operations. Conversely, the asset management company can update its programme of operations, pending prior approval by the Autorité des Marchés Financiers, so as to acquire the right to conduct such activities.

#### Specific case of derivatives on hedge fund indexes

Collective investment undertakings are entitled to use derivatives on hedge fund indexes, provided that the programme of operations of the asset management company qualifies for the use of financial contracts, also referred to as “financial instrument derivatives.”

Using this option requires the asset management company to check that the index complies with the criteria according to which it can be characterised as a financial index, pursuant to Article R. 214-16 of the Monetary and Financial Code. In this context, the asset management company must check in collaboration with the Autorité des Marchés Financiers that it has the required organisational structure, human and technical means to operate as an “alternative fund of funds.”

Finally, it is recalled that the key investor information document and the prospectus of the collective investment undertaking must provide adequate information.

### **1.2. Due diligence to be conducted in the event of a merger between a UCITS and other collective investments**

Scope: UCITS

Pursuant to article 411-3 of the AMF General Regulation, a UCITS cannot transform itself into a different collective investment and cannot possibly undergo a transformation having equivalent effects. Accordingly, it is excluded that a UCITS be split, being replaced by a UCITS and a different collective investment.<sup>2</sup>

However, a UCITS may merge with a different UCITS or another collective investment.

If the absorbed fund is a UCITS, the management company shall ensure, prior to the merger, that the countries in which the absorbed UCITS is marketed are countries in which the receiving UCITS is marketed.

### **1.3. Due diligence to be conducted for the monetization of a collective investment undertaking using portfolio insurance techniques**

Scope: Collective investment undertakings

---

<sup>2</sup> Excluding the specific regime governing side pocket funds.

Certain UCITS and AIFs apply a portfolio insurance-type technique (e.g. CPPI).

In such cases, one of the risks associated with this type of management is the risk of monetization.

The asset management company must act in the best interests of investors. Among other things, it must:

- study the likelihood of the UCITS or AIF being exposed to risky assets once again;
- determine whether there are grounds or not to carry out a transfer or dissolution of the UCITS or AIF.

This approach must make it possible to avoid any situation in which the monetarized UCITS or AIF no longer delivers any performance, for example, without any prospect of change.

As a general rule, all management companies must consider whether it is appropriate to accept subscriptions to a UCITS or AIF whose performance is very limited due to a cushion that has become too small.

#### **1.4. Due diligence to be conducted when using financial contracts the underlying of which is a real estate index**

Scope: Collective investment undertakings

In order to be eligible as underlying assets to the financial contracts (or financial instrument derivatives) entered into by a collective investment undertaking, financial indexes must meet the requirements set out in I of Article R214-16 and in I of Article R.214-22 or in Article R. 214-32-25 and in I of Article R. 214-32-30 of the Monetary and Financial Code on the composition and representativeness of the index and its mode of dissemination.

Among financial indexes can be found indexes related to yearly completed real estate transactions completed in a country, a geographical region or a given sector.

Besides, in order to meet its valuation obligation, the management company is required to assess the depth and efficiency of the market for the financial contracts linked to the index chosen.

Consequently, this means that the management company must address both the issue of the eligibility of the index as an asset of a collective investment undertaking and also the depth and efficiency of the market to which it refers.

Moreover, management companies are reminded that they must check whether or not using these instruments is compliant with the programme of operations approved by the AMF before they start using them.

Index-tracking UCITS must comply with AMF Position DOC-2013-06 – Exchange-traded funds and other UCITS issues

#### **1.5. Due diligence to be conducted when introducing gates in real estate funds, professional real estate funds, professional investment funds and funds of alternative funds**

Scope: Real estate collective investment undertakings (OPCI)/Professional real estate collective investment undertakings/Professional investment funds/Funds of alternative funds

Introducing gates allows redemptions to be deferred on the basis of several net asset values as soon as they exceed a certain threshold, determined in an objective manner.

Passive management must be compatible with the gates introduced. In that respect, before they implement the gates, management companies are required to contact their depository and the concerned service providers in

order to check the compatibility of the contemplated scheme, both as regards flow processing and the information provided to investors.

#### 1.5.1. Description in the prospectus

The functioning of the gates must be described accurately in the prospectuses of the AIFs concerned.

#### 1.5.2. The method chosen

The method chosen shall be consistent with the structure of the fund's assets and liabilities.

It is necessary that the threshold above which gates may be activated is not such as to undermine the open nature of the AIFs concerned.

In the case of a professional investment fund or fund of alternative funds whose net asset value is fixed on a monthly basis, this requirement is considered to be complied with when the threshold is not lower than 10% of its net assets. Moreover, management companies shall determine the periodicity for calculating the net asset value when the professional investment fund or the fund of alternative funds uses a gate mechanism. Indeed, while it is possible to introduce gates amounting to 10% of the net assets with a net asset value calculated on a monthly basis, it is impossible to introduce a gate amounting to 0.5% of each daily net asset value as it would result in the professional investment fund or fund of alternative funds losing its open nature.

In the case of real estate funds, excluding professional real estate funds, gating thresholds should enable holders to be repaid at least 2% of the fund's net assets every month, and redemption requests should be executed and settled within one year at most from receipt of the order, including notice periods. This gate threshold is possible only for a real estate fund whose documentation explicitly refers to the illiquid nature of its units or shares.

The level of non-executed orders shall be determined after the end of the period dedicated to centralising the orders. This meets the need to inform the concerned investors at the earliest opportunity and aims to give them the possibility to submit, in compliance with the notice deadlines and if they so wish, a new order for the fraction of non-executed orders (see item on the execution of orders).

The trigger threshold of the gates is calculated on the basis of the amount of redemptions, minus the amount of subscriptions.

- Real estate collective investment undertakings (OPCI)/Professional real estate collective investment undertakings/Funds of alternative funds offering only one category of units:

For such AIFs, the threshold at which the gate is triggered is calculated at the end of the period dedicated to centralising the orders by calculating the number of redemptions minus the number of subscriptions, expressed in terms of shares, in relation to the total number of units of the latest net asset value. The threshold may also be measured in amounts under the following conditions.

- Real estate collective investment undertakings (OPCI)/Professional real estate collective investment undertakings/Funds of alternative funds offering several categories of units:

These AIFs may set different thresholds for triggering the gate depending on the categories of units.

For AIFs of this type, the threshold at which the gate is triggered is measured at the end of the period dedicated to centralising the orders. The redemptions, minus subscriptions, expressed as an amount (number of units multiplied by the latest net asset value), are calculated as a proportion of the latest net asset value.

If indicative net asset values have been calculated previously, they can be endorsed. Overall, the management company shall make the necessary adjustments to determine the reference net assets on the basis of the information it was provided with since the net asset value was last calculated.

The net asset values used for net redemptions (numerator) expressed in amounts are those related to the net assets used in the calculation (denominator).

Back-and-forth transactions, for a same number of units and executed on the basis of the same net asset value and by a single investor or beneficial owner, are not included in the calculation of the gates. They may escape being fractionated insofar as the prospectus provides for it. This provision allows avoiding that an investor who completes a back-and-forth transaction has its redemption order fractionated while a subscription order of a similar amount offsets the impact of this redemption order on the AIF.

#### 1.5.3 Procedures for triggering the gates

The management company is free to trigger the gate mechanism, as provided for in the prospectus. Before it makes this decision, it shall ensure that the principle of investors' fair treatment is being complied with. It must act in the interest of the remaining investors and avoid the risks of conflicts of interests.

The decision of triggering the gates shall only be made in the interest of the remaining investors. The gates shall not be negotiable by investors submitting orders on the basis of a unique net asset value. Should the management company decide not to trigger the gates for a net asset value, the decision shall be documented and held at the AMF's disposal.

#### 1.5.4 Order execution

Orders exceeding the level at which the gate is triggered are not executed. The rules governing the reduction of orders must ensure that investors leaving the fund are treated fairly. Reducing the orders to the same extent for all investors is usually the most appropriate mechanism. However, it shall be adapted to suit certain complex gate mechanisms such as the schemes under which the orders placed within a certain threshold are executed first and the number of orders exceeding that threshold are reduced in order to meet the gate requirements. Management companies may potentially be required to adapt the characteristics of the fund's units so as to allow partial execution, either by reducing the value of the units or by fractionating them.

Moreover, management companies shall determine and specify in the prospectus of the AIF if the non-executed orders will be cancelled or deferred and executed on the basis of the following net asset value. This point shall be assessed in the light of the overall liquidity management scheme, and more particularly by taking into consideration the consequences resulting from systematically deferring the orders that would help maintain systematic demand for redeeming units in the AIF concerned. Management companies shall also assess the fact that introducing a scheme under which orders are automatically deferred incites investors to bring forward their redemption requests in order to secure a place in the waiting line. As regards this peculiar issue, they shall ensure, together with the relevant market participants (depositaries, centralist,...), that the scheme can be operated.

Where the scheme depends on non-executed orders being deferred and executed on the basis of the following net asset value, deferred orders have no priority over the new redemption orders to be executed on the basis of the current net asset value. Should redemption orders be fractionated once again on the basis of the current net asset value, they shall be fractionated under the same conditions as the new subscription orders. This principle makes it possible once again to avoid investors who wish to leave the AIF being penalised by redemption orders previously submitted by other investors. It also helps reduce the risk that investors might be tempted to bring forward their redemption orders to secure a place in the waiting line.

Given the necessity to submit orders once again or to defer them, management companies are required to determine a periodicity for determining the net asset value and notice periods which allow investors to submit their orders again. Management companies cannot possibly escape their obligation to inform investors about the mandatory notice periods. The management companies shall provide for arrangements for identifying the deferred orders or the orders that were submitted again in accordance with the mandatory notice period. Investors shall not be penalised by being prevented from deferring their orders or submitting them again on the basis of the following net asset value. Indeed, it is necessary to comply with this schedule in order to be able to initiate the transactions in the AIF's net assets in a timely manner (the underlying hedge funds for instance).

Introducing gates can prove to be a sensitive issue, for operating reasons, when the frequency for setting the net asset value is high (a daily or weekly frequency for instance).

#### 1.5.5. Order cancellation

The management company shall ensure that orders submitted prior to the order centralisation date cannot possibly be changed, including through cancellation requests which could be assimilated to late trading operations. Moreover, the management company shall not give any details on the level of the subscription and redemption orders placed that would have an investor anticipate whether the gate is likely to be triggered or not.

#### 1.5.6. Investor information

In the event of cancellation, investors of whom a fraction of orders has not been executed shall be informed of it within timeframes allowing them to submit the non-executed orders on the basis of the next net asset value. The procedures for informing investors are provided for in the AIF's prospectus.

### 1.6. Due diligence to be conducted in the monitoring of formula funds

When the management company acquires a financial instrument derivative, it must not base itself solely on the valuation from the counterparty, but must perform its own counter-valuation. The difference between the price from the counterparty and that obtained by the internal valuation must be carefully monitored throughout the lifetime of the fund in order to avoid any unjustified leaps in the net asset value<sup>3</sup> linked to any catch-up processes, in particular at maturity, when the valuation of the financial instrument derivatives results from the application of a contractual formula. An inappropriate valuation during the lifetime might lead to any holders making redemptions during this period being penalised by an excessively low valuation.

## 2. MANAGING COLLECTIVE INVESTMENT UNDERTAKINGS REACHING MATURITY

### 2.1. Management in the investors' interest and minimum amount of assets under management

Scope: UCITS/Retail investment funds/Private equity funds/Funds of alternative funds/Professional investment funds/Declared funds

The minimum asset under management thresholds set by the regulations are low: €300,000 for common funds and open-ended investment companies (SICAV).<sup>4</sup> Many management strategies require a higher minimum amount of assets under management in order to be implemented in the interest of the investors. It is the duty of the management company or collective investment undertaking to make the necessary arrangements for:

---

<sup>3</sup> This targets any unjustified movements in the net asset value. Some movements in the net asset value may be inevitable at maturity due to the Bid-Mid spread when the fund is not the subject of a bid valuation on the last day, for example.

<sup>4</sup> Except for dedicated funds (Article 422-94 of the AMF General Regulation) and formula funds (Articles 411-21, paragraph 4 and Article 422-22, paragraph 4 of the AMF General Regulation).



- identifying the situations under which the fund's net assets are likely to become too low for the fund to be managed in the interest of the investors;
- defining and implementing measures aimed at ensuring that the fund is managed in the interest of the investors: looking for new subscriptions to preserve the fund's net assets at a sufficient level, transformation, mergers or winding-ups if it is impossible to preserve the fund's net assets at a sufficient level.

Accordingly, it is not acceptable to wait systematically that the fund's net assets fall below the minimum amount of assets under management before implementing corrective measures. The decisions on the future of a collective investment undertaking shall be made exclusively in the investors' interest and shall by no means give precedence to the interest of the management company over that of the investors.

A management company notes that the fund's net assets are decreasing on a regular basis and that they will inevitably fall below the €300,000 minimum amount of assets under management. It believes that the fund has no commercial future and that it must consequently be liquidated. However, it considers that the fund can still be managed despite the decline in its net assets. The management company does not want to be seen as the party which is initiating the fund's liquidation, fearing this will undermine its image amongst its clients. Accordingly, it decides to wait for the fund's net assets to fall below the €300,000 minimum amount of assets under management and stay below this threshold for more than 30 days before making the decision to liquidate the fund. This allows the management company to present its decision to its clients as the direct consequence of a regulatory provision and not as a decision of its own.

This method is not compliant with the regulation because:

- it leads the management company to give precedence to its own interest (its image amongst customers) over that of the investors in the fund (who, on the one hand, invest in a fund which is soon to be liquidated without knowing it and, on the other hand, will suffer the consequences of the fund's liquidation when submitting their redemption requests in the next few weeks);
- the information provided to investors is not "clear, accurate and non-misleading" since it presents the fund's liquidation as the consequence of a regulatory provision while it is in fact a decision of the management company itself.

Moreover, it is recalled that the management strategy implemented by the collective investment undertaking shall be consistent with the strategy described in the prospectus in all circumstances. The fact that the fund's net assets no longer make it possible to implement the management strategy shall prompt the management company or the fund to ask themselves why they failed to anticipate the situation and to take all the necessary corrective measures.

It does not justify implementing a management strategy that would not be consistent with that defined in the prospectus.

The management strategy implemented by a European Union Equity fund requires that the fund's net assets are at least €10 million. The fund is almost exclusively held by a life-insurance company which marketed it to its clients in the form of unit-linked life insurance contracts. The life-insurance company decides to create units in the fund, which results in the capital of the fund being greatly reduced, though remaining above the €300,000 minimum amount of assets under management. The management company notes that the fund has no future and that outflows from the fund continue. It decides to have the fund invested in monetary assets until its assets under management fall below €300,000 and then liquidate it. The management company fails to inform the remaining investors about this decision and about the change in the management strategy. This method is not compliant with the regulation insofar as:

- the way the fund is managed is not consistent with the content of the prospectus;
- the information provided to investors is not "clear, accurate, and non-misleading".

If the fund's medium-term sustainability is not undermined and if the management strategy is in the interest of the current or future investors, the 30-day period provided for in the regulation can be used to secure new subscriptions.

Conversely, if the fund's medium-term sustainability is undermined, or if the management strategy proposed by the fund is not intended to be continued, the fund can file for transfer (liquidation, merger, demerger or absorption) with the Autorité des Marchés Financiers before the end of the 30-day notice period. Pursuant to Articles 411-21 and 422-22 of the AMF General Regulation, the transfer process becomes mandatory when the net assets have remained for 30 days below the fund's minimum amount of assets under management.

#### - Blocking redemptions when the fund's assets fall below the minimum amount of assets under management

After it saw some funds file for liquidation because their assets had fallen below the minimum amount of assets under management, the Autorité des Marchés Financiers realised that not all service providers had established an organisational structure suited to ensure that the provisions of Articles 411-21 and 411-22 of the AMF General Regulation are being complied with.

Accordingly, the Autorité des Marchés Financiers reiterates that the redemption of units or shares shall be blocked as soon as measurement of the fund's net assets reveals that the latest movements in the fund's assets or liabilities have resulted in the fund's assets falling below the regulatory minimum amount of assets under management.

The management company of a common fund whose net assets stood at €350,000 when the net asset value was last calculated and falls to €280,000 when calculating the new net asset value shall not execute any redemption orders as of this date.

Moreover, considering the impact on investors of the fund's assets falling below the regulatory minimum amount of assets under management (which results in redemption orders being blocked), the management company shall take all the necessary steps to anticipate such situations as much as possible and to minimise the impact on investors. The approach mentioned in the previous part will make it possible to achieve such an objective.

The assets of an open-end investment company (SICAV) decrease on a regular basis and are likely to fall below the €300,000 minimum amount of assets under management. The management company waits for the assets to fall below this threshold before starting to think about the measures to be taken in collaboration with the SICAV's management. It may take several weeks to consider the different steps to be taken (merger, liquidation, resuming subscriptions) and to implement them (approval by the Autorité des Marchés Financiers, calling for an extraordinary general meeting). Investors consequently have their redemption orders blocked for several months. This situation is not compliant with the regulation. The necessary steps shall be taken to shorten the period during which redemption orders are blocked.

Failure to comply with the aforementioned principles led some asset management companies to offer business courtesies to the fund or investors harmed in order to compensate for their loss when they had their redemption orders blocked for a long period of time.

## **2.2. Executing significant redemption orders, in particular when the collective investment undertaking is close to the regulatory threshold**

Scope: Collective investment undertakings

When the management company or the collective investment undertaking receives redemption orders accounting for a significant proportion of the fund's liabilities and which could result in the undertaking falling below the minimum amount of assets under management, it shall ensure that meeting its obligation to execute

orders so as to avoid that executing redemption orders leads to unfair treatment between investors who submitted a redemption order and the investors who retained their units (or shares) does not undermine its ability to manage the fund in the interest of the remaining investors.

Accordingly, a management company that receives a redemption order accounting for 60% of the fund's net assets, valued at €1,200,000, should ensure that it is still able to manage the collective investment undertaking despite the sharp decline in its net assets. Should it become incapable of managing the fund in such circumstances, the management company can, pursuant to Article L.214-7-4, 214-8-7, L. 214-24-33 or L. 214-24-41 of the Monetary and Financial Code, suspend redemptions in the investors' interest. It shall then make the necessary decisions in a timely manner to resume redemptions or liquidate the collective investment undertaking.

Finally, if the redemption orders concerned are submitted by an entity linked to the management company or to a significant client, particular attention must be paid to identifying and addressing the conflicts of interests arising from this situation.

An investor (a subsidiary of the management company) holding 50% of the assets of the collective investment undertaking asks for its units to be redeemed. The management company knows that executing this order would have the fund fall below the minimum amount of assets under management. In this context, it must take the necessary steps to ensure that the exit of this investor does not penalise the remaining investors.

In order to anticipate this sort of issue, management companies may implement redemption ceiling mechanisms or gates in the conditions set out in Instruction DOC 2017-05.

### **2.3. Organising liquidation**

Scope: Collective investment undertakings

As soon as it is decided that the fund will be liquidated and that the conditions for the assets to be realised require a change in the investment policy, the decision must be communicated to investors on the same day the liquidation is announced. This decision shall first be approved by the AMF when the fund files for transfer.

Moreover, it shall be highlighted that selectively informing certain investors that the assets might drop below the minimum amount of assets under management is a breach of the obligation to treat unit holders or shareholders fairly such as to engage the liability of the management company or collective investment undertaking. The orderly liquidation of the collective investment undertaking, whether it is decided by the management company or by the management of the undertaking, is usually a solution which reduces litigation risks.

The management company informs the two biggest investors in the fund, which, taken together, account for more than 50% of the fund's assets, that the assets of the common fund are getting close to €300,000. The two investors submit redemption orders which result in the fund falling below the €300,000 threshold. This practice is not compliant with the regulation since the management company communicates the information to a reduced number of investors who are able to exit from the fund while those who have not been informed have their investment in the fund blocked until the asset management company makes a decision on the future of the fund.

#### **Specific case of early dissolution/transfer of a collective investment undertaking implementing a buy and hold strategy**

Collective investment undertakings implementing this type of strategy are intended to continue until the maturity date set out in their legal documentation. Early dissolution should occur only in exceptional circumstances and the management company must be able to provide justification for it in light of the interests of the investors.

In the case of the dissolution/merger/transfer of a fund implementing a buy and hold strategy before its maturity date, it is necessary to report on a certain number of points in the information supplied to investors. The reasons leading the management company to make this decision must therefore be clear. The reasons are accompanied by a summary table comprising the following elements:

- the actuarial rate since the launch against the rate fixed on the launch of the fund.
- The net residual actuarial rate until maturity (including the hypotheses of a management company default).

As a general rule, all management companies must analyse whether it is appropriate to accept subscriptions to a portfolio with a very limited performance and whether they should modify its management even in the investment time horizon has not yet been reached.

## **2.4. Valuation rules**

Scope: Collective investment undertakings

In the event of outflows from the fund, it is important that the methods for valuing the assets of the collective investment undertaking be clearly defined so that investors can exit from the fund on the basis of a net asset value which reflects market reality.

The management company or the collective investment undertaking shall ensure, under such circumstances, and more particularly in the event of important outflows from the fund, that the on-balance and off-balance positions are sold or unwound respectively, under terms compatible with the principles for valuing the assets of the collective investment undertaking. Indeed, a poor match between the price at which the assets are sold and the valuation conditions means that the remaining investors are likely to suffer the consequences of limited or increased exposures to the market when they unwind their positions, which may ultimately have major impacts on the net asset value of the collective investment undertaking.

Where a collective investment undertaking which replicates the CAC 40 index receives redemption orders amounting to 95% of its assets and if a spread of 1% is recorded between the price at which undertaking's assets are valued and the price at which they are sold, this difference will be passed onto the investors who hold the remaining 5% of the assets. This means that the impact on these investors will be 20 times higher than the impact of the market variation. The initial spread of 1% will have an impact of 20% on the remaining investors.

## **2.5. Liquidation of ETFs (including in merger operations)**

Scope: Collective investment undertakings admitted for trading on a regulated or organised market (ETF)

"The specific characteristics of ETFs and the financial markets on which they are traded (one or several markets) may require the implementation of specific arrangements on dissolution of a listed collective investment undertaking, including within the framework of a merger.

Particular vigilance must be afforded to the stages described in the offer document for investors setting out the arrangements for subscription and redemption orders on both markets (secondary and primary) and also for the delisting of the collective investment undertaking (disappearance from the secondary market)

Given the specific characteristics of ETFs and the markets on which they are traded, a technical memo must be submitted to the AMF when applying for approval of liquidation, presenting the main aspects of the operation and a detailed timeline for the different stages in the transaction. "

Practical example:<sup>5</sup>

- Date of suspension of the subscription and redemption orders on the two markets (secondary and primary) in relation of the date of information of the holders: it is accepted that the suspension of the subscription and redemption orders on the two markets of the ETF should not come immediately after the holders are informed, but should only be a few days before liquidation. The regulations and statutes of the ETF will need to be modified beforehand. This modification will not be subject to approval by the AMF but must be the subject of communication to the holders by all or any means.

These specific arrangements in no way remove the obligation for the collective investment undertaking to comply with the regulatory suspension threshold of €300,000: if the net assets of the collective investment undertaking should pass below the regulatory threshold between the date of communication and the suspension of subscriptions/redemptions, the management company would then be obliged to immediately suspend the orders on the primary and secondary markets, pursuant to Article 411-21 of the AMF General Regulation for UCITS and Article 422-22 of the AMF General Regulation for AIFs;

- Date of suspension of subscription and redemption orders on the primary market in relation to that on the secondary market: two methods are possible:

Option 1: the suspension of subscription and redemption orders on the secondary market (delisting) and on the primary market are on the same day, a few business days before the effective execution of the transaction

Option 2: the delisting of the ETF (disappearance from the secondary market) comes two days before the date of suspension of subscription and redemption orders on the primary market. This difference is appropriate when the daily time limit for placing orders on the primary market is before the closing time of the secondary market. This option therefore makes it possible for market makers to intervene on the primary market until the closing time of the secondary market in order to unwind their different positions, which will therefore not be blocked until the effective date of the dissolution transaction.

For ETF merger operations, the scheme below is generally applied to the disappearing ETF.

However, these specific arrangements are not always adapted to ETFs tracking a market considered as not very liquid or illiquid. For these ETFs, the suspension of subscription and redemption orders on the two markets is usually carried out as soon as the information is disclosed to the holders.

### 3. SIDE POCKET AIFS

Pursuant to Article L. 214-8-7 or Article L. 214-24-41 of the Monetary and Financial Code, the demerger of UCITS/retail investment funds/private equity funds/funds of alternative funds/professional retail funds/professional specialised funds/professional private equity funds/employee investment funds gives rise to two collective investment undertakings. The first is dedicated to receive the assets the sale of which do not serve the investors' interest (side pocket AIF) and the other is meant to receive the other assets of the collective investment undertaking (replicated fund).

These types of demergers are intended to deal with an exceptional situation that undermines the value of some of the assets of the collective investment undertaking. Accordingly, deciding to create a side pocket AIF shall remain exceptional and concern only certain identified assets.

---

<sup>5</sup>This is an example of the practice followed by actors. There are other ways of proceeding, depending in particular on the markets concerned.

### **Recommendation**

**Prior to the creation of the side pocket AIF, it is recommended that the collective investment undertaking or its management company contact the *Autorité des Marchés Financiers* in order to draft the statement to be communicated to the AMF and write the information to be provided to investors in the fund.**

### **3.1. Must the replicated collective investment undertaking be approved by the AMF?**

Articles L. 214-8-7 and L. 214-24-41 of the Monetary and Financial Code provides that the split need not be approved by the AMF but shall be immediately notified to it.

Consequently, provided that only the absence of the assets transferred to the side pocket AIF distinguishes the assets of the replicated collective investment undertaking from those of the split collective investment undertaking, the replicated collective investment undertaking born out of the demerger shall not file for approval again with the AMF insofar as it benefits from the accreditation of the split collective investment undertaking.

Conversely, if the replicated collective investment undertaking demonstrates other differences with the split collective investment undertaking in its investment strategy or in the way in which it operates, it shall be subject to the applicable rules governing the transformation of collective investment undertakings, in particular as regards the information to be provided to investors, the right of investors to exit free of charge or the procedures to be followed to be granted approval by the AMF.

### **3.2. Notification to the AMF: content and procedures**

Demergers decided pursuant to Article L. 214-8-7 or Article L. 214-24-41 of the Monetary and Financial Code shall be immediately notified to the AMF.

This notification shall include:

- A copy of the demerger decision: the minutes of the extraordinary general meeting of the open-ended investment company (SICAV) to be demerged or the copy of the decision of the management company which manages the common fund to be demerged;
- the list of the assets transferred to the side pocket AIF;
- a technical note justifying the volume of the assets transferred to the side pocket AIF;
- the report justifying and detailing the terms of the demerger decision, which shall be transmitted to investors, pursuant to Articles D. 214-5, D. 214-8, D. 214-32-12 and D. 214-32-15 of the Monetary and Financial Code;
- the full prospectuses of the replicated collective investment undertaking and side pocket AIF;
- the mails and documents intended to inform investors about the demerger, whatever the mode of communication chosen;
- The fund deposit certificates of the two collective investment undertakings that were born out of the demerger.

This notification shall be communicated to the AMF by email or mail.

This notification is deemed to constitute filing with the AMF for the creation of a side pocket AIF, which shall be necessarily incorporated as a professional specialised fund.

This declaration does not exempt the concerned collective investment undertaking or the management companies managing the fund from complying with the formalities required for demergers or for the creation of a collective investment undertaking (Euroclear formalities, declaration at the court registry, etc.)

Finally, the statutory auditors' report is communicated to the AMF as soon as it is drafted.

### **3.3. Procedures for informing investors**

Articles D. 214-5, D. 214-8, D. 214-32-12 and D. 214-32-15 of the Monetary and Financial Code provide that investors in the split collective investment undertaking be informed immediately about the demerger by the split collective investment undertaking or its management company and that the rationale and procedures for the demerger and be transmitted to them.

This information, which is of particular nature, needs to be communicated individually to all investors. It can be supplemented with general information, which can be disseminated through a news release for instance.

Articles D. 214-5, D. 214-8, D. 214-32-12 et D. 214-32-15 of the Monetary and Financial Code also state that the split collective investment undertaking or the management company provide investors with prospectuses and, where applicable, the Key Investor Information Documents for the two collective investment undertakings born out of the demerger.

The mail intended to inform investors about the realisation of the demerger shall indicate how they can have access to these documents or how they can obtain them upon request.

In addition to the aforementioned procedures for informing investors, the split open-ended investment company or its management company shall also comply with the provisions set out in Articles 422-98 et seq. of the AMF General Regulation on the procedures to be followed in the event of demergers involving collective investment undertakings.

### **3.4. Which assets can be transferred to a side pocket AIF?**

Since Articles L. 214-8-7 and L. 214-24-41 of the Monetary and Financial Code do not provide for any limitation in respect of the legal nature of the assets that can be transferred to a side pocket AIF, all assets whose sale would not be in the interest of the investors in the split collective investment undertaking may, a priori, be transferred to a side pocket AIF.

It is the duty of the split collective investment undertaking or its management company to list the assets which must be transferred to the side pocket AIF. However, it should be recalled that the decision to create a side pocket AIF shall remain exceptional and concern only certain identified assets. Accordingly, mere difficulty in valuing or selling certain assets may not lead them to think that selling them would not be in the interest of the investors.

Moreover, the split collective investment undertaking or its management company shall ensure that:

- the contemplated demerger is possible given the particular circumstances of the collective investment undertaking. The existence of frame agreements or prime brokerage agreements entered into by the collective investment undertaking soon-to-be demerged or the creation of collateral by this collective investment undertaking can be obstacles to completing the demerger;
- the assets to be transferred to the side pocket AIF are eligible for such a transfer. Indeed, the transfer of certain types of assets may be subject to conditions such as the agreement of a contractual partner (for over-the-counter financial futures instruments for instance).

### **3.5. What is run-off management?**

Articles D. 214-5, D. 214-8, D. 214-32-12 and D. 214-32-15 of the Monetary and Financial Code provide that side pocket AIFs must be managed in a run-off mode. This means that:

- any type of active management is prohibited. Only the management acts aimed at protecting the interest of the investors and at ensuring that the fund's liquidation is completed in the best possible conditions are authorised;

- the number of units or shares in a side pocket AIF is determined when the fund is demerged and it remains the same until full liquidation of the side pocket AIF. Indeed, the side pocket AIF is not allowed to issue new units or shares and it shall not honour any redemption requests. However, it gradually depreciates the existing units or shares in compliance with the principle of investors' fair treatment.

When the split collective investment undertaking or its management company considers that selling the assets transferred to the side pocket AIF is in the interest of the investors again, the said assets can be sold. The depreciation of the units or shares in the side pocket fund can then be realised immediately or subsequently. It requires the side pocket AIF to ensure that it has the liquidities necessary to run off its assets (so as to honour margin calls for instance).

Moreover, market conditions or the interest of investors in the side pocket AIF may lead to certain assets being sold at maturity only.

### **3.6. What is implied by the legal nature of the replicated and split collective investment undertakings, provided for in Articles D. 214-5, D. 214-8, D. 214-32-12 and D. 214-32-15 of the Monetary and Financial Code?**

The replicated collective investment undertaking must have the same legal nature, investment rules and operating rules as the split collective investment undertaking. As an illustration, the replicated collective investment undertaking created by the demerger of a general open-ended investment company must be a general open-ended investment company. Likewise, the replicated collective investment undertaking created by the demerger of a professional investment fund must be a professional investment fund.

However, the side pocket AIF always takes the form of a specialised professional fund pursuant to Articles D. 214-5, D. 214-8, D. 214-32-12 and D. 214-32-15 of the Monetary and Financial Code.

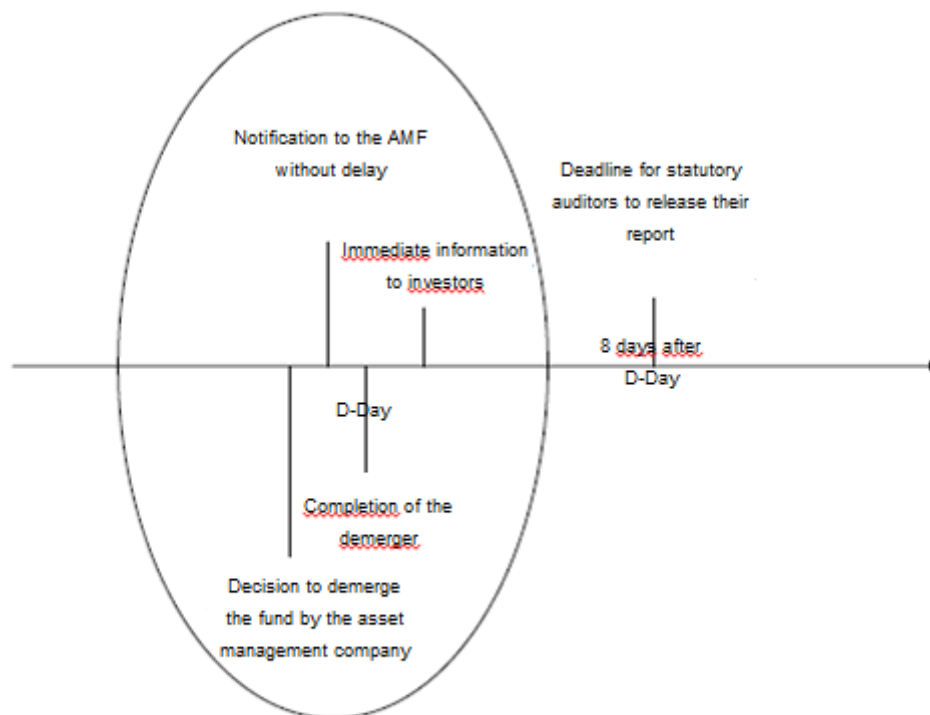
### **3.7. Why do common fund demergers benefit from a specific regime?**

All demergers of open-ended investment companies or common funds decided on pursuant to Articles L. 214-7-4, L. 214-8-7, L. 214-24-33 or L. 214-24-41 of the Monetary and Financial Code benefit from the application of a less stringent regime since these mergers are not subject to approval by the AMF and are only declared.

However, only the regime governing demergers of collective investment schemes was amended by Decree 2008-1312 dated December 12, 2008, as open-ended investment companies are still governed by common law rules on demergers of public limited liability companies and simplified public limited companies provided for in the Commercial Code. Accordingly, demergers of open-ended investment companies remain governed by the existing regime, as set out in Articles 412-5 and onwards and Articles 422-98 and onwards of the AMF General Regulation.

Timeline of a common fund merger decided pursuant to Article L. 214-8-7 or Article L. 214-24-41 of the Monetary and Financial Code:





Transactions which can be completed without delay

**3.8. Are Instructions 2011-19 and 2011-20 applicable in the event of a merger decided pursuant to the second paragraph of Article L. 214-8-7 or the second paragraph of Article L. 214-24-41 of the Monetary and Financial Code?**

Yes. Instructions 2011-19 and 2011-20 specify the applicable procedure.

**3.9. Does a demerger decided pursuant to Article L. 214-8-7 or Article L. 214-24-41 of the Monetary and Financial Code give investors in the split collective investment undertaking the right to exit free of charge?**

No. A demerger decided pursuant to Articles L. 214-7-4, L. 214-8-7, L. 214-24-33 or L. 214-24-41 of the Monetary and Financial Code does not induce substantial changes in the rights of investors insofar as investors in the split collective investment undertaking become investors in the two collective investment undertakings born out of the demerger which, brought together, combine the rights they had in the single collective investment undertaking before.

**3.10 Can the replicated collective investment undertaking be marketed?**

Yes. The marketing conditions of the replicated collective investment undertaking are identical to those of the split collective investment undertaking.

### **3.11 Can past performances of the split collective investment undertaking be mentioned in the documents (prospectus, marketing materials, etc.) of the replicated collective investment undertaking?**

First of all, it should be highlighted that the replicated collective investment undertaking is allowed to create a performance history as of its incorporation date only and that it is not allowed to use the performance history of the split collective investment undertaking or to link, in any way, its own performance history to that of the split collective investment undertaking.

However, given the specific character of the demerger that led to the creation of the replicated collective investment undertaking, it may be allowed that the documents (prospectus, marketing materials, etc.) of the replicated collective investment undertaking mention the performance history of the split collective investment undertaking, provided that they clearly indicate that:

- the performance history is not that of the replicated collective investment undertaking,
- the replicated collective investment undertaking was born out of the demerger, which was decided so as to create a side pocket AIF out of the collective investment undertaking of which the performance history is presented.

### **3.12 Can a side pocket AIF be transformed, merged or demerged?**

Although the transformation, merger or demerger of a side pocket AIF, necessarily incorporated in the form of a professional specialised fund, is not explicitly prohibited by Law, the fact that it must be managed in a run-off mode precludes a priori that it be subject to such mutation.

If a side pocket AIF were to be exceptionally merged or demerged, this transformation should be justified by considerations specific to the management of a side pocket AIF.

## **4. COMPENSATION PROCEDURE**

Scope: Collective investment undertakings

Professionals may opt for compensation solutions, short of a tort action in court. The Autorité des Marchés Financiers encourages the concerned professionals to compensate the investors who might have been harmed by their failure to fulfil their duties, yet without imposing any obligation in this matter.

The AMF has no jurisdiction to deal with compensation for the prejudice suffered by investors in a collective investment undertaking. However, it wishes to be informed by the concerned professionals about the steps taken in the event of compensation.

### **4.1. Impact analysis**

A management company may decide to provide financial compensation for the prejudice suffered by investors in a collective investment undertaking.

The prejudice suffered by investors can, for instance, be the result of valuation or management errors or of failure to comply with the provisions set out in the prospectus, etc.

It is recommended that as soon as the management company becomes aware that investors in one of its collective investment undertakings have suffered a prejudice, it should contact the fund's statutory auditor, its depositary and the Autorité des Marchés Financiers to inform them about these events.

The management company will have to conduct an analysis detailing the following:

- the origin of the error, the period during which it was made and the steps taken by the asset management company to prevent this situation from reoccurring;
- the impact of the error on the collective investment undertaking and on each investor (in amounts and percentage of the net asset value);
- the corrective measures contemplated by the management company to repair the prejudice suffered and the potential threshold under which it considers the loss suffered too small to be compensated (the choice of the threshold shall be reasonable and determined by the management company, based on the nature of the collective investment undertaking, of the investors, etc.)

As part of the impact analysis, it is recommended that the management company take into account the changes in the minimum amount of assets under management during the concerned time period, re-calculate the fund's net asset value for the time period running from the origin of the mistake to the date at which the mistake was corrected and the prejudice suffered compensated and assess the significance of the impact. The management company shall also analyse the impact of these changes on the performance of the collective investment undertaking over the aforementioned period.

We will take the example of a collective investment undertaking of which the published net asset value is false (undervalued) due to a valuation error of a financial instrument in which the collective investment undertaking invested. In this context, investors who exited the collective investment undertaking or who retained their holding in the collective investment undertaking during the concerned time period suffered a loss and the fact that investors acquired units in the collective investment undertaking on the basis of a net asset value that was undervalued also caused the collective investment undertaking to suffer a loss. The management company is then required to take into consideration all these circumstances when calculating compensation.

As soon as a mistake has been identified, the management company may endeavour to compensate for the prejudice suffered by the fund or by the investors. Three situations have to be distinguished: compensation for the collective investment undertaking, compensation for those investors who subscribed for units and compensation for those who redeemed units in the fund.

- Compensation for the collective investment undertaking: Such compensation can be approved in particular in the event of a loss or when investors subscribed for units on the basis of a wrong and lower net asset value, thereby yielding lower returns and causing the already existing investors to suffer a loss.
- Compensation for investors who have already subscribed for units in the fund on the basis of an overvalued net asset value.
- Compensation for investors who redeemed units in the fund on the basis of an undervalued net asset value. Since the management company is responsible for setting and publishing the net asset value, it cannot, in practice, require investors who subscribed for units on the basis of an undervalued net asset value to pay additional money to match the real net asset value nor can it return units redeemed on the basis of an overvalued net asset value.

The management company, and not the collective investment undertaking, shall bear the costs associated with the compensation scheme. Should the collective investment undertaking partially bear the costs associated with a compensation scheme, the management company will have to prove that this is in the investors' interest.

#### **4.2. Settlement and compensation of the prejudice suffered**

Once the impact analysis is completed, the management company is allowed to compensate the collective investment undertaking and its investors.

In order to ensure proper record-keeping, the management company is required to provide the Autorité des Marchés Financiers with the following:

- the principles adopted as regards the method, calculation and efficiency of the compensation mechanism, supplemented with the assessment of the fund's statutory auditor on these issues;
- the provisional timeframe for the compensation payments supplemented with the list of all the investors and intermediaries if possible;
- the information that will be provided to investors who suffered a loss.

## 5. CLASSIFICATIONS, CALCULATING EXPOSURE AND OVERALL RISK

With the exception of the "short-term money market", "money market" and "formula fund" classifications referred to in Articles 30-7 and 30-8 of Instruction DOC-2011-19, Articles 30-7 and 30-9 of Instruction DOC-2011-20, Articles 30-7, 30-9, 30-10 and 30-11 of Instruction DOC-2011-21 and Annexes I.1 and III.1 of Instruction DOC-2012-06, the fund classifications referred to below shall be maintained only at the discretion of the collective investment undertaking.<sup>6</sup>

For collective investment undertakings that have elected to eliminate this classification or not to use a classification, all exposure and/or investment limits related to the abandoned classification must be included in their regulatory documents. These limits must be respected at all times, whether they are derived from regulatory documents or management rules specific to the collective investment undertaking.

Collective investment undertakings that refer to one of the classifications referenced in (i) Articles 30-1 to 30-6 of Instruction DOC-2011-19, (ii) Articles 30-1 to 30-6 and 30-8 of Instruction DOC 2011-20 and (iii) Articles 30-1 to 30-6 of Instruction DOC-2011-21 or (iv) Annexes I.1 and III.1 of Instruction DOC-2012-06 in their regulatory documents and that have elected to no longer use this classification will have to delete this reference from their regulatory documents.

Lastly, collective investment undertakings that decide to no longer use the classifications will be required, as soon as they abandon their classification, to enter one of the ECB classifications, as indicated below, on their GECO extranet for the purpose of reporting to the Banque de France under Regulation (EU) 1073/2013 concerning statistics on the assets and liabilities of investment funds:

Denomination
Equity fund
Bond fund
Mixed fund
Real estate fund
Hedge fund
Other fund

### 5.1. Taking into account all financial instruments when calculating exposure

Scope: UCITS/Retail investment funds/Funds of alternative funds/Professional investment funds/Employee investment funds

Articles 30 et seq. of Instruction DOC-2011-19, Instruction DOC-2011-20 and Instruction DOC-2011-21 define the different categories to which a collective investment undertaking can belong. Belonging to a given category

---

<sup>6</sup> No action is required by the collective investment undertaking to maintain the AMF classification.

depends on several criteria, including most of the time an exposure criterion. Accordingly, a fund belonging to the “French equity” category must have exposure of at least 60% to the French equity market.

As provided for in Article 30-10 of Instruction DOC-2011-19, Article 30-11 of Instruction DOC-2011-20 and Article 30-12 of Instruction DOC-2011-21, calculating the fund’s exposure requires taking into account contractual transactions, financial contracts and securities with embedded derivatives in addition to physical investments. Since the purpose of segregating collective investment undertakings into different categories is to give an overview of their sensitivity to the price movements in the different markets, it is necessary that the derivatives and securities with embedded derivatives in the fund’s portfolio be taken into account on the basis of the value of their equivalent underlying (“delta”).

In that respect, using a reverse certificate that would offer reverse exposure to the performance of an equity index would reduce overall exposure to the equity markets. Besides, it would be impossible to measure the contribution of this instrument to the exposure on the basis of its market value insofar as such a calculation would overlook the sensitivity of the instrument to the underlying market.

Moreover, it should be recalled that pursuant to Article 30-10 of Instruction DOC-2011-19, Article 30-11 of Instruction DOC-2011-20 and Article 30-12 of Instruction DOC-2011-21, the units or shares in sub-funds held by the investor collective investment undertaking shall be accounted for in the calculation of the investor collective investment undertaking’s exposure by taking into account their own categorisation.

For instance, a fund that invests at least 70% of its assets in “French equities” collective investment undertakings and the remaining 30% in money market instruments, without using derivatives, would be considered as having an exposure of 70% to the French equities markets and would be classified as a “French equity” fund.

## **5.2. Compliance with the rules imposed by the categorisation or set out in the key investor information document (KIID) and in the prospectus**

Scope: UCITS/Retail investment funds/Private equity funds (retail private equity investment funds, retail venture capital funds and retail local investment funds/Funds of alternative funds/Employee investment funds

Pursuant to Article 30 of Instruction DOC-2011-19 and Instruction DOC-2011-20, each collective investment undertaking shall mention in its key investor information document (KIID) and in its prospectus the category to which it belongs and complies at all times with the criteria governing its category, set out respectively in Articles 30-1 and 30-09 of Instruction DOC-2011-19 and Articles 30-1 to 30-10 of Instruction DOC-2011-20.

The four “Equities” categories share the common feature of a minimum exposure requirement of 60% to the equity markets of a specific geographical region.

In order to ensure that the criteria governing the category are complied with and to ensure coherence within this category, the Autorité des Marchés Financiers stipulates that Equity collective investment undertakings must have simultaneous exposures of 60% to the overall equity risk and of 60% to the equity risk linked to their geographical region.

Thus, for instance, a euro zone equity collective investment undertaking which invests 60% of its assets in euro zone equities and reduces its exposure to the equity risk by selling Swiss equity futures would fail to comply with the criteria governing its category as its overall exposure to the equity markets would be lower than 60%.

Lastly, it is recalled that all the exposure limits and/or investment limits set out in the prospectus, whether they arise from the categorisation or from investment rules specific to the collective investment undertaking, shall be complied with at all times.

We will take the example of an “International equity” collective investment undertaking of which the prospectus mentions an exposure range to the equity markets, all geographical areas combined, of between 70% and 100%.

The fact that the asset management company forecasts a decline in the equity markets does not give the collective investment undertaking the right to reduce its exposure to the equity markets to less than 70%.

### **5.3. Clarification of the definition of ancillary risk**

Scope: UCITS/Retail investment funds/Private equity funds (retail private equity investment funds, retail venture capital funds and retail local investment funds/Funds of alternative funds/Professional investment funds/Professional specialised funds/Professional private equity investment funds

For certain categories, exposures to currency or market risks which differ from that of the concerned geographical zone shall remain ancillary. The Autorité des Marchés Financiers considers, in that respect, that any exposure to a specific risk exceeding 10% of the fund's assets cannot possibly be considered ancillary.

Accordingly, a collective investment undertaking with exposure of more than 10% to US bonds cannot fall in the category "bonds and other euro-denominated debt securities".

Moreover, the notion of ancillary risk used in the prospectus shall reflect the marginal nature of the said exposure. The aforementioned 10% limit can prove inadequate for certain categories of funds or certain types of management. An exposure below 10% cannot be considered ancillary then.

Accordingly, a diversified collective investment undertaking which mainly invests in money market instruments and which has an exposure of 8% or 9% to the commodity markets in order to outperform cannot pretend that such exposure is ancillary insofar as it is a performance driver and entails a significant degree of risk for the collective investment undertaking.

#### **Holding ancillary liquid assets**

Scope: UCITS/Retail investment funds/Private equity funds/Funds of alternative funds/Professional investment funds/Employee investment funds

Holding ancillary liquid assets may be justified, for example, in the following cases:

- in order to cover current or exceptional payments;
- in the case of sales of the fund's assets, for the time necessary to reinvest in other financial instruments;
- for a period of time strictly necessary when, because of unfavourable market conditions, the investment in financial instruments must be suspended.

Pursuant to paragraph 5.3 of this Position-Recommendation, it is considered in this regard that any exposure to a specific risk exceeding 10% of the fund's assets could not be qualified as ancillary. Where exceptional market conditions justify it, however, it is considered that a collective investment undertaking may increase this limit to 20% for liquid assets. In all cases involving UCITS, retail investment funds, professional investment funds, funds of alternative funds and employee investment funds, the liquid assets held, cumulated with the exposure to the factors mentioned in III of Article R. 214-21 and Article R. 214-32-29 of the Monetary and Financial Code, may not exceed 30%.

### **5.4. Calculating overall risk in the case of arbitrage strategies**

Scope: UCITS/Retail investment funds/Private equity funds/Real estate funds/Funds of alternative funds/Employee investment funds/Professional investment funds

Pursuant to Articles 411-72 et seq. and Articles 422-51 to 422-60 of the AMF General Regulation, the performance achieved by a collective investment undertaking using the commitment calculation method is based on directional risks and should not be significantly based on trade-offs between these sources of risk. Therefore,

a collective investment undertaking that uses trade-off strategies in a non-marginal manner, notably in the interest rate and currency markets, shall not use the commitment calculation method to calculate overall risk and shall use the VaR calculation method instead.

Determining the “material” character is left to the discretion of the asset management company. However, it shall rely on several criteria such as the contribution of the trade-off strategies to the fund’s performance or risk profile. It cannot, most of the time, rely exclusively on the calculation of the percentage of the assets or exposure allocated to this strategy insofar as such a criterion does not ensure that the said strategy is not an important performance driver of the fund.

For instance, the fact that a trade-off strategy accounts for only 10% of the fund’s assets does not imply necessarily that the performance depends significantly on this strategy.

The commitment calculation method can be used if the proportion of non-standard financial instruments is negligible.

### **5.5. Offsetting exposure to index futures with a basket of equities as part of the commitment calculation method**

Scope: UCITS/Retail investment funds/Private equity funds/Real estate funds/Funds of alternative funds/Employee investment funds/Professional investment funds

Articles 411-75, 422-54 and 422-176 of the AMF General Regulation allows offsetting of exposure to index futures with a basket of assets replicating this index. Offsetting is possible as soon as a basket of assets replicates the underlying index to the futures positions.

Accordingly, it is impossible to offset exposure to an index derivative with only one asset.

We will take the example of a collective investment undertaking which almost exclusively invests in French equities, save for one German stock with a put option on the DAX index. It is impossible to offset the short position on the DAX with the German stock on the grounds that the reference markets are the same because the stock does not replicate the DAX.

In addition, it should be specified that offsetting depends on the quality of the replication. In that respect, where the basket of assets does not exactly replicate the index, offsetting cannot be total and should be adjusted with a replication coefficient which takes into account several criteria such as the tracking error, correlation or the weight of the stocks in the index. It is the duty of the management company to define the coefficient applied and ensure that the criteria adopted are consistent with the replication effectively implemented.

Where a collective investment undertaking invests in 20 stocks in the CAC 40 and that it also sells futures on the index, the short position can partially be offset with the basket of shares by taking into account the correlation between the performance of the basket of 20 stocks and that of the index when determining the offsetting level for instance.

### **5.6. Using the VaR calculation method when measuring overall risk**

Scope: UCITS/Retail investment funds/Private equity funds/Real estate funds/Funds of alternative funds/Employee investment funds/Professional investment funds

Pursuant to Articles 411-71-1 et seq., 422-50 et seq. and 422-176 of the AMF General Regulation, a collective investment undertaking using the VaR calculation method to measure overall risk may lay out a reference portfolio with the same risk profile (or the same allocation) as that of the collective investment undertaking. The VaR of the collective investment undertaking is then compared to the reference portfolio’s VaR (relative VaR).

When the management company chooses not to lay out a reference portfolio, the regulatory requirements governing overall risk command that the VaR of the collective investment undertaking be compared to a fixed threshold (absolute VaR).

It shall be reminded that:

- this choice must be justified;
- a collective investment undertaking which fails to comply with the requirements of the predetermined calculation method cannot change its method (“breach”);
- if the risk profile can easily change, the relative VaR cannot be used;
- the reference portfolio is based on a non-leveraged benchmark (with not leverage effect).

### **5.7. Distinction between the historical VaR and the ex post VaR**

Scope: UCITS/Retail investment funds/Private equity funds/Real estate funds/Funds of alternative funds/Employee investment funds/Professional investment funds

The Autorité des Marchés Financiers noticed, in the context of monitoring collective investment undertakings and asset management companies, that there seems to be confusion between the notions of historical VaR and ex post VaR.

The historical VaR is one of the methods usually used by the financial industry to calculate the VaR. It is based on the assumption that the distribution of returns observed from the historical data will happen again in the future. It consists of reconstituting the return history of the static portfolio on the basis of the historical returns of the different risk factors present in the portfolio at the time of calculation and over the time period considered and then determining the percentile of the series obtained corresponding to the target confidence level.

Where there are 250 historical data and where the confidence level stands at 99%, the historical VaR is the third value in the ordered list of the portfolio’s reconstituted performances.

The ex post VaR is the maximum dynamic loss suffered by the real portfolio over a set time frame, depending on a determined confidence threshold in a given time period.

If the ex post VaR (99%, 1 day) of a fund over a twelve-month period is 3%, this means that the fund achieved a daily performance of more than [-3%] in 99% of the cases in the past year.

In a nutshell, the historical VaR measures the ex ante risk and makes it possible to estimate the probabilistic loss suffered by a portfolio on the basis of its composition at the time of calculation while the ex post VaR is a result that reflects the dynamic behaviour of the portfolio afterwards.

### **5.8. Backtesting VaR models**

Scope: UCITS/Retail investment funds/Private equity funds/Real estate funds/Funds of alternative funds/Employee investment funds/Professional investment funds

Pursuant to II of Article 15 of Instruction 2011-15, the VaR models used need to be backtested in order to ensure that the net asset value of the collective investment undertaking is consistent with the risk measurement procedures used.

The backtesting method has to be defined by the asset management company and it must suit the strategies implemented and the management methods adopted.



We will take the example of a collective investment undertaking which calculates its VaR (99%, 20 days) at each net asset value determination date.

As part of the backtesting process, the management company can, for instance, compare the weekly performance of the collective investment undertaking with the estimated probabilistic loss measured by the VaR and, then, count the number of times when the performance has been lower than the VaR over the time period considered. The overshooting percentage (also called exceptions) can then be compared to the 20% threshold (to which it is assumedly very close), which is the risk threshold corresponding to the confidence threshold for calculating the VaR (99%)

Conversely, comparing the fund's ex post VaR to the risk threshold may not be considered, in most cases, the only sufficient backtesting method to validate a model, although it allows a preliminary consistency check.

## 6. INFORMATION TO INVESTORS

### 6.1. Determining the investment objective on the basis of market assumptions made by the management company

Scope: Collective investment undertakings

The management company shall ensure that the investment objective of the collective investment undertaking is consistent with the investment strategy it looks to implement to reach the said objective, in particular when it plans setting a quantified performance objective. Indeed, although the latter is not a commitment to results, it shall nevertheless be defined on the basis of assumptions likely to occur.

Asset management companies which carry out simulations of past performances to justify setting a performance objective in the Key Investor Information Document (KIID) and in the prospectus of a collective investment undertaking shall be able to take into consideration the limits of the simulation carried out and the particular circumstances (notably specific market conditions) of the time period over which these simulations are carried out. It is necessary that the quantified performance objective be consistent with the nature of the risks entailed by the investment strategy.

In the case of equity markets yielding an annual return on investment of 7% over a five-year time period, an equity collective investment undertaking, managed on the basis of a backtested quantitative model over a three-year time period of strong rally in the equity markets, cannot set an annual performance objective of 10% on this basis alone.

### 6.2. Consistency of certain types of UCITS transformations or of certain movements in liabilities with the information provided to investors

Scope: Collective investment undertakings

In the case of some specific transformations of collective investment undertakings (for instance, the transformation of a UCITS into a feeder UCITS or the opposite, mergers), the management company shall ensure that the practical arrangements for the transformation are not likely to undermine the exposure to which investors are entitled under the prospectus predating and postdating the transformation.

We will take the example of an index UCITS replicating the CAC 40 index which becomes the feeder fund of a master UCITS, yet using the same management strategy. It seems natural that investors in the fund should not be temporarily desensitised to price movements in the CAC 40 index during the transformation. They shall continue

to benefit from an index-based management strategy without being impacted by the transformation procedures (deadline for subscribing for units in the master fund, subscription net asset value, valuation procedures).

Similarly, where these transformations result in important subscription/redemptions orders, the management company shall ensure:

- on the one hand, that these movements in the liabilities do not result in important changes in the risk profile of the collective investment undertaking which may affect investors who retain their units during the interim period;
- on the other hand, that these movements in the liabilities do not result in excessively high friction costs associated with changes in the assets under management.

Accordingly, a management company which is aware that some of its investors intend to transform their direct exposure to a collective investment undertaking into exposure to this undertaking through a feeder collective investment undertaking shall take steps to ensure that the exposure of the collective investment undertaking to equities does not vary disproportionately during the successive divestment and reinvestment stages and that other investors in the collective investment undertaking are not impacted by the transaction or commission fees associated with these sharp movements in the structure of the fund's liabilities.

### **6.3. Mergers and information to investors**

Scope: Collective investment undertakings

Overall, mergers are carried out by exchanging units in the receiving collective investment undertaking for units in the absorbed collective investment undertaking. Although this action is not considered a subscription, and consequently not strictly governed by the investment conditions of the receiving collective investment undertaking, the merger shall not aim at circumventing the receiving collective investment undertaking's investment conditions. Thus, it is the duty of the management company to ensure, prior to the launch of the merger, that the conditions for purchasing units or shares in the receiving collective investment undertaking are equivalent to the conditions for purchasing units or shares in the absorbed collective investment undertaking which prevailed when it was marketed.

For instance, if the subscription amount of the receiving collective investment undertaking is lower than €100,000 while the subscription amount of the absorbed collective investment undertaking is €1,000, the planned merger would allow investors in the absorbed collective investment undertaking to invest in the receiving collective investment undertaking although the investment conditions of the two are different. Conversely, if the subscription amount of the absorbed collective investment undertaking is €1,000 and the receiving collective investment undertaking is transformed prior to the merger in order to align the investment conditions of the receiving collective investment undertaking with those governing the absorbed collective investment undertaking, the investment conditions of the two collective investment undertakings are then equivalent and the merger may be completed.

Besides, in the specific case of mergers involving a receiving fund offering several categories of units, if the units held by investors in the absorbed fund are transferred to a single category of units for practical reasons, the draft letter to be sent to the investors shall:

- highlight the existence of other categories of units;
- offer investors who meet the investment conditions the possibility to transfer their assets to the category of their choice in order to benefit from more favourable tariff conditions.

#### **6.4. Informing investors about the guaranteed principal amount**

Scope: UCITS/Retail investment funds/Private equity funds/Real estate funds/Real estate investment trusts/Funds of alternative funds/Professional investment funds/Professional real estate funds/Declared funds/Employee investment funds/Film investment funds

Where a collective investment undertaking or investors in a collective investment undertaking are being offered a redemption guarantee for some or all of the invested capital, investors shall be informed precisely about the amount of the guarantee in the regulatory documents.

For instance, if the guarantee does not cover the subscription fees, this should be mentioned in the regulatory documents. Similarly, if the guarantee is before tax, this information shall be clearly mentioned in order to provide investors with accurate information.

See also AMF Position-Recommendation DOC 2011-24 and AMF Position-Recommendation DOC 2011-05.

#### **6.5. Consistency of the information provided in the Key Investor Information Document (KIID) and in the prospectus with the information disseminated in the marketing materials of the collective investment undertaking**

Scope: Collective investment undertakings

The information disclosed in the Key Investor Information Document and in the prospectus when the collective investment undertaking files for approval shall always be consistent with the information disclosed in the marketing materials. Management companies are required to pay particular attention to this issue.

The marketing materials of a collective investment undertaking which promotes an investment strategy based on the selection of small caps from emerging countries cannot possibly suggest that this investment outperforms a European blue-chip index.

This remark may also apply to the regulatory documents released by the collective investment undertakings which do not articulate a key investor information document and prospectus.

#### **6.6. Marketing AIFs reserved for 20 investors**

Scope: AIFs

Reserved AIFs shall not be listed, advertised, sold or be subject to any other type of solicitation to the general public. This category of investors is intended to subscribe to AIFs incorporated on demand of a limited number of investors (a maximum of 20 persons). The funds concerned shall not be actively marketed, even though they are aimed at a limited number of investors.

Besides, the fact that these funds are reserved for specific investors implies that the regulatory documents they release are not available to the general public. For purposes of consistency, they cannot be communicated to funds open to all investors since this would be like distributing to the general public funds which are meant to be held by a limited number of investors.

#### **6.7. Transformation of a fund established with a pre-determined time horizon (excluding formula funds)**

Scope: Collective investment undertakings, excluding formula collective investment undertakings

### Dissolution

Several funds have filed with the AMF for early dissolution before the maturity date initially set for the management strategy.

These files are particular insofar as dissolution would occur before the planned maturity date, thereby allowing investors to have their units or shares redeemed before the end of the investment period on the basis of which they subscribed and on the basis of which the collective investment undertaking should have been managed initially. Moreover, where investors have their capital guaranteed at maturity, early dissolution would prevent them from benefiting from this guarantee within the anticipated timeframe.

These files require that the right balance be found between investor protection and the requirements imposed on the management companies. Indeed, these requirements can prove to be so stringent that early dissolution becomes preferable, in the interests of the investors, to continuing to manage the fund. This may be the case where a fund using an insurance portfolio strategy is forced to invest in monetary assets because of a sharp decline in the markets.

The AMF shall then review the conditions under which the management company takes into account the interest of the investors and the potential loss they could suffer, the loss of opportunity, the subscription fees and the other costs associated with the dissolution.

### Transformation

Some management companies have developed and marketed collective investment undertakings according to a pre-determined maturity date and wish to transform these products into similar products at maturity.

It is desirable that these transformations give rise to a positive action by the investor so that its subscription in the fund is not tacitly extended. However, failing this, it is possible to change a collective investment undertaking built for, and marketed over, a pre-determined time period which has expired into a product using the same investment strategy and having the same time horizon, provided that the following conditions are met:

- the new fund shall leave enough time to investors to make their investment decision (i.e. holding their units) depending on the frequency of the net asset value calculation and have their exposure to dynamic assets renewed at the end of this period only. During this period, investors shall have the possibility to redeem units free of charges.

#### Example:

- o - a two-week time period for a fund with weekly liquidity is not enough.
  - o - a one-month period for a fund with daily liquidity is a possible option.
- the information provided to investors, by mail and before the fund expires, shall contain several pieces of information. It shall specify that the new investment product has been conceived in continuity with the preceding investment and the management procedures shall be stipulated. A new investment objective shall be proposed by the asset management company. Two assumptions shall be proposed in the letter:
  - o should the investor wish to recover the capital initially invested, or should he decide to shift to a new investment profile, it must be offered the possibility to have its shares redeemed.
  - o conversely, should the investor wish to invest in a similar product and subscribe for units in a fund with a pre-determined investment period, the asset management company shall inform the said investor that it retains its units and that it holds units in the new fund.

## 7. MONITORING OF EXCHANGE-TRADED FUNDS (ETFs)

### Recommendation

**In the event of a significant reduction in the liquidity of the underlying assets of an index followed by an ETF, or significant valuation problems, it is recommended that the asset management company promptly inform the AMF of its action plan and justify its written decision to suspend or continue honouring subscriptions and redemptions on the primary market, in the best interests of the holders.**

**Considering the management of ETFs, if the fund lends or borrows securities or uses OTC derivatives, the AMF recommends that the asset management company draw up an action plan including the various options in terms of managing the ETF if one or more counterparties defaults, in the best interests of the holders.**