

## AMF position – recommendation 2007-21

### Professional obligations towards retail clients imposed on investment services providers managing a portfolio on behalf of a third party

Reference texts: articles 314-44, 314-60 and 314-66 IV of the AMF General Regulation

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The doctrinal elements presented in this document come, in part, from the analysis of the reports on the conditions under which the professional obligations imposed on investment services providers managing a portfolio under a discretionary management agreement towards clients who are natural persons arise, which was addressed to the *Autorité des Marchés Financiers* in 2005. This analysis was published in the AMF monthly review 35 (April 2007).

**Unless recommendations are specifically identified as such, the doctrinal elements contained in this document are positions.**

#### 1. Procedures for entering into a business relationship with the client and associated controls

##### Recommendations

As regards the Procedures for entering into a business relationship with the client, the AMF recommends:

- That the compliance and internal control officer (RCCI) and investment services compliance officer (RCSI) of the entities concerned be strongly involved in developing and validating, a priori, the process aimed at ensuring that the service proposed suits the objective, experience and situation of the future client;
- That a copy of all the complaints and/or litigations filed by the client be sent to the compliance and internal control officer (RCCI) and investment services compliance officer (RCSI);
- To ensure that the obligation set out in 5° of Article 314-60 of the AMF General Regulation, which requires that the clients who allow transactions in financial contracts on their behalf give special and explicit consent for this purpose, is being enforced;
- That the investment services compliance officer (RCSI) and compliance and internal control officer (RCCI) primarily control the agreements with high-risk management objectives.

## **2. Management agreements entered into by retail investors and related information**

### **2.1. General conditions on the form and content of the discretionary management agreement on behalf of a third party entered into by a retail client**

Pursuant to the provisions of Article L. 533-14 of the Financial and Monetary Code and 314-59 of the AMF General Regulation, the discretionary management agreement entered into by a retail client shall be written on paper or on any other durable medium.

The discretionary management agreement shall be drawn up in duplicate, with both copies signed by the client and the investment services provider. One of the two copies is given to the client.

Pursuant to Article 314-58 of the AMF General Regulation, the discretionary management agreement entered into by a retail client must indicate the pieces of information set out in Article 314-59 and 314-60 of the AMF General Regulation.

When the discretionary management agreement indicates the classification that was chosen for the investment services provider by its providers<sup>1</sup>, it shall stipulate that this classification does not affect the classification chosen by the investment services provider for its client and that it has no impact on the obligations of the investment services provider towards its client. Accordingly, an asset management company or investment services provider may be classified by its providers as a professional client or as an eligible counterparty, without this affecting the classification of the client (which may be classified as a retail client for instance) on behalf of which it manages the portfolio and places orders.

### **2.2. The management objective described in the discretionary management agreement entered into by a retail client**

Article 314-60 of the AMF General Regulation provides that the discretionary management agreement indicate *“the management objectives.”*

The management objectives shall be clearly set out and defined according to the objectives, experience and situation of the client. The discretionary management agreement must indicate the recommended investment period.

It may also provide for the distribution of investments by asset classes, the description of a reference indicator, the existence of a floor and/or ceiling on certain types of financial instruments or a reference to a certain type of management.

The asset management companies operating under a discretionary management agreement have the possibility to implement a discretionary management policy, i.e. a management which provides that the composition of the portfolio may change according to the management policy deemed appropriate by the asset manager, provided that the mandate indicates explicitly and clearly the specificities, the advantages and disadvantages associated with this type of management.

Monitoring the situation of the client shall be an ongoing process and the management objectives of the agreement shall be reviewed with the client according to the changes in the situation of the client.

### **2.3 Financial instruments and transactions authorised when managing the portfolio of a retail client**

The discretionary management agreement shall specify the categories of financial instruments that the portfolio can contain. Unless provided otherwise and pursuant to 2° of Article 314-60 of the AMF General Regulation, the instruments authorised are:

- a) “the financial instruments listed on a regulated market or on a regulated market that operates regularly in a country that is not a Member State of the European Community nor party to the European Economic Area agreement, provided that this market is not on a list of excluded markets drawn up by the *Autorité des marchés financiers*;

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<sup>1</sup> This concerns situations where the provider of investment services to third parties has recourse to other service providers.

- b) the European collective investment schemes (CIS) compliant with the UCITS Directive 2009/65/CE dated 13 July 2009 and the AIF governed by French Law accessible to all investors;  
c) Derivative contracts traded on a market which are on the list set forth in a ministerial decree<sup>2</sup>.”

Pursuant to Article 314-60 of the AMF General Regulation, *“when the terms of the contract allow transactions in financial instruments other than those referred to in Point 2° or leveraged instruments, particularly transactions in financial contracts, the client must give special and explicit consent, with a clear indication of the instruments authorised, the procedures for these transactions and for reporting to the client“.*

As such, the agreement shall define explicitly, and on a restrictive basis, the transactions authorised, in terms of the markets or instruments concerned, in terms of the type of the transactions and in terms of risk limits. It particularly targets hedging and/or speculative transactions authorised under the agreement, the maximum losses authorised or the fraction of the portfolio exposed to these markets and/or instruments...

The agreement shall feature the following statement: *“Any other transaction that those listed in here is forbidden”.*

Unless provided otherwise, long settlement transactions shall be settled upon expiry and cannot be rolled over.

#### **2.4. Other pieces of information provided in the agreement entered into by a retail client**

The discretionary management agreement entered into by a retail client provides in an explicit manner that the investment services provider can subscribe for shares in collective investment schemes managed by the asset management company or an affiliated company, pursuant to Article 313-24 of the AMF General Regulation<sup>3</sup>.

Where appropriate, the agreement may indicate that the investment services provider can outsource the management of part or the entire portfolio, without informing the client or securing its approval.

Any change in the method used for calculating the compensation of the investment services provider shall be subject of an amendment to the management agreement.

Where the client chooses the custody account-keeper on a proposal from the investment services provider, the conditions and fees charged by this intermediary shall be provided to the client by the investment services provider and they shall be set out in the appendix to the agreement.

#### **2.5. Transparency in fees in the agreement**

The discretionary management agreement entered into by a retail client shall indicate, in a comprehensive manner, all the direct and indirect costs and fees charged to the client, pursuant to Article 314-42 of the AMF General Regulation and, where appropriate, the possibility for the investment services provider to receive rebates on subscription-redemption fees and/or management fees when managing the portfolio.

#### **2.6. Information to be provided to the client on the management of its portfolio**

The investment services provider provides its client with a periodic statement of the portfolio management activities executed on its own behalf on a durable medium, unless such a statement is provided by another person.

Pursuant to the provisions of Articles 314-91 and 314-95 of the AMF General Regulation, when the client is a retail client, the investment services provider must provide the client with a periodic statement containing the pieces of information referred to in Article 314-94 of the AMF General Regulation.

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<sup>2</sup> Ministerial decree dated 6 September 1989 for application of Act 88-1201 of 23 December 1988.

<sup>3</sup> For persons mentioned in Article 316-2 of the AMF General Regulation, Article 318-14 of the AMF General Regulation for their AIF management activity.

This statement must be provided on a quarterly basis upon request of the retail client and at least once a month when the agreement allows leverage on the portfolio.

Professional or retail clients can also chose to be provided with the key information on the transaction after it has been executed. In such cases, and when it involves a retail client, the periodic statement containing the information referred to in Article 314-94 of the AMF General Regulation must be provided at least once a year unless in the case of transactions involving:

a) “A financial instrument referred to in Article L. 211-1 of the Monetary and Financial Code provided that it carries the right to buy or sell another financial instrument, or gives rise to a cash payment, determined by reference to financial instruments, a currency, an interest rate or rate of return, commodities or other indices or measurements;

b) A financial contract, as defined in III of Article L. 211-1 of the Monetary and Financial Code.”

The article specifies that in the cases referred to in a) and b), the information shall be provided once every six months.

Pursuant to article 314-96 of the AMF General Regulation, “where a retail client elects to receive information about executed transactions on a transaction-by-transaction basis in accordance with Article 314-92, the investment services provider must send him a notice confirming the transaction and containing the information referred to in Article 314-89 no later than the first business day following that execution or, if the confirmation is received by the investment services provider from a third party, no later than the first business day following receipt of the confirmation from said third party.

*The preceding paragraph shall not apply where the confirmation would contain the same information as confirmation that is to be promptly dispatched to the retail client by another person”.*

Pursuant to article 314-97 of the AMF General Regulation “Where investment services providers provide portfolio management for a retail client whose portfolio includes an uncovered open position in a contingent liability transaction, they shall also report to the retail client any losses exceeding any predetermined threshold, agreed between the provider and the client, no later than the end of the business day on which the threshold is exceeded or, in a case where the threshold is exceeded on a non business day, the close of the next business day.”

### **3. Procedures for executing the portfolio discretionary management agreement and the associated controls**

#### **3.1 The suitability of the service to the client’s needs and the management orientation of the client’s portfolio**

In compliance with Article L. 533.13 of the Monetary and Financial Code, “in order to provide the portfolio management service for a third party, investment service providers are required to ask their clients, in particular before entering into a business relationship with them, about their investment knowledge and experience, as well as their financial situation and investment objectives so as to be able (...) to manage their portfolio in a manner that is appropriate to their situation.”

The *Autorité des Marchés Financiers* notes that the rules for checking the suitability of the services provided to the clients’ needs apply both when entering into a business relationship with the client and when amending the agreement (see also AMF Position 2013-02 – Collecting ‘Know-your-client’ information).

#### **Recommendation**

The AMF urges the investment services providers to pay particular attention to the information they provide to their clients when the latter leave them a great deal of latitude in managing their portfolios and it recommends that investment services compliance officers (RCSI) and compliance and internal control

officers (RCCI) focus on controlling these portfolios, as well as those which are composed of atypical, risky or leveraged instruments.

Investment services providers must establish standards in the most comprehensive and accurate manner for the nature of the specific management orientations and for the latitude that clients wish to give to them under the management agreement.

*Investment in funds open to professional investors or foreign funds that are not eligible for marketing in France*

When the mandate authorises<sup>4</sup> transactions concerning funds open to professional investors<sup>5</sup> or foreign funds that are not eligible for marketing in France<sup>6</sup>, the investment services provider will, in compliance with Article 314-44 of the AMF General Regulation, ensure that:

- this option meets the client's investment objectives,
- the client is financial able to confront any risk related to implementation of this option, and this risk is compatible with the client's investment objectives,
- the client has the experience and knowledge necessary to understand the risks inherent in this option.

It is noted that in application of Article 314-60 of the AMF General Regulation, the option of investing in funds option to professional investors and foreign funds that are not eligible for marketing in France will be provided by in the management mandate. It will also be subject to an express agreement that clearly states the types of funds that are authorised and conditions for informing the client.

**Recommendation**

If the mandate provides the option of investing in funds open to professional investors or foreign funds that are not eligible for marketing in France, the AMF recommends that the mandate state the maximum share of the portfolio of the customer that can be invested in said funds, which shall be adapted to the client's profile (i.e., the client's investment objectives, financial situation, experience and knowledge).

Implementation of this recommendation may take place<sup>7</sup>:

- immediately for new mandates,
- at the next modification of the mandate contract or its specific conditions for current mandates that provide for the option of investing in such products.

**3.2 The investment service provider responsible for managing the portfolio and the custody account-keeper**

**Recommendation**

The AMF recommends that when it uses the services of a custody account-keeper to send certain documents such as the periodic statement, the investment services provider shall ensure that this delegation of duties is standardised and shall make sure to systematically reconcile in advance the positions of its clients with those accounted for by the custody account-keeper.

<sup>4</sup> This refers to either the initial signing of the contract or an amendment to said contract.

<sup>5</sup> The funds may adopt exceptional investment rules and the offering or acquisition or, where appropriate (when it concerns the funds declared), the sale or transfer of units of these funds, directly or by an intermediary, is reserved for certain investors. In addition, the declared funds are not approved by the AMF.

<sup>6</sup> Subject to the laws that apply to said funds.

<sup>7</sup> If, obviously, this has not yet taken place.

Besides, insofar as there is a direct legal connection between the client and its custody account-keeper, in which the investment services provider does not intervene, the AMF reminds that an investment services provider cannot decide to transfer the securities of a client from one custody account-keeper to another without the express agreement of their common client.

Indeed, the protection of the client's assets is an important issue (the obligation for the custody account-keeper to return the assets of its clients is provided for in 3° of Article 322-4 of the AMF General Regulation).

Since it is in the investment services provider's best interest to have its clients open an account at a designated custody account-keeper with which it has agreed upon the operating processes, it must commit to ensuring that the way its clients enter into a business relationship with the said custody account-keeper complies with the regulatory requirements.

### **3.3. The projected allocation of orders**

In order to offer sufficient guarantees in terms of pre-allocation of orders, the order allocation software used must provide a final and unhackable time-stamping procedure and it shall not contain any untraceable reallocation mechanism.