AUTORITÉ DES MARCHÉS FINANCIERS
AMF

Public consultation by the AMF on proposals to update its policy concerning ETFs governed by French law

1. Context, objectives and practical arrangements for this consultation

1.1. Context and objectives

ETFs have experienced explosive growth in recent years: in Q3 2016, their assets under management reached €2,852 billion, i.e. 7% of total assets under investment management worldwide and a 20% annual increase in assets over the last four years. Against this backdrop of rapid growth, the AMF is closely monitoring developments in this market and its impact, particularly in terms of liquidity and stability.

The AMF is submitting to public consultation three proposed amendments to its policy with the aim of adapting and strengthening the applicable framework. These proposals are subject to consultation during a two-month period, from 24 March 2017 to 24 May 2017.

1.2. Who is this consultation aimed at?

This consultation is aimed at:

- investors and their representatives;
- portfolio management companies;
- credit institutions;
- investment firms;
- professional associations;
- consumer associations;
- law firms, particularly those working within the financial industry.

1.3. Response procedure and deadline

This consultation will end on **24 May 2017**. Participants are invited to send their responses and comments to the following address: **directiondelacommunication@amf-france.org**

2. Proposals being put forward for consultation

This public consultation relates to the following four proposals.

2.

2.1. Proposal 1: To clarify the option for ETFs governed by French law of repaying in-kind redemption applications on the primary market (except in the event of liquidation).

For all ETFs governed by French law,[1] there is a proposal to enable the management company to honour in kind redemption applications by authorized participants (APs)[2] on the primary market (except in the event of liquidation).

[1] In accordance with articles (i)(*a*) L. 214-7, paragraph 4, L. 214-8, paragraph 2 and I (listed UCITS) and II (exchange-traded UCITS) of article D. 214-22-1 of the Monetary and Financial Code (***MFC***), (*b*) L. 214-24-29, paragraph 4, L. 214-24-34, paragraph 2 and I (listed retail investment funds (***RIFs***), excluding dedicated RIFs referred to in article L. 214-26-1) and II (exchange-traded RIFs) of article D. 214-32-31 of the MFC, (*c*) L. 214-139, R. 214-183 and R. 214-183-1 of the MFC (listed alternative funds of funds (***AFFs***)) and (*d*) L. 214-143, R. 214-187 and R. 214-187-1 of the MFC (listed retail professional funds (***RPFs***)) and (ii) 411-134 (exchange-traded UCITS) and 421-72-1 (listed RIFs, AFFs and RPFs) and 421-27-2 (exchange-traded 'AIFs') of the AMF General Regulation (***AMFGR***), these ETFs are collective investment undertakings whose shares or units can be admitted for trading on a regulated financial instruments market

AMF instructions 2011-19 and 2011-20,[3], applicable respectively to (i) UCITS and (ii) RIFs (retail investment funds), AFFs (alternative funds of funds) and RPFs (retail professional funds) currently provide redemption for common funds exclusively in cash, except in the event of the fund's liquidation when unitholders have given their agreement to be redeemed in securities,[4] while nothing is specified for SICAVs.[5] There is therefore a proposal to insert in these instructions specific text related to redemption in kind, concerning solely ETFs. The proposed new wording is presented in Annex II. It would comprise the following text:

When the fund is an ETF, redemptions on the primary market may exceptionally be conducted in kind except in the event of the fund's liquidation, under conditions defined in agreement with the unitholders or shareholders.

As a reminder, only APs and certain professional investors intervene on the ETF primary market. The proposed redemption in kind will not therefore concern retail investors.

To ensure equality of treatment of unitholders or shareholders, the management company must be capable of redeeming a subset of securities representative of all the ETF's underlying assets, particularly in terms of liquidity. It would not in fact be necessary for an investor to obtain the fund's most liquid securities, to the detriment of the remaining unitholders or shareholders.

The option for the management company of honouring redemption applications in kind could facilitate its liquidity management. This is because, in highly degraded liquidity conditions, the management company might transfer to the AP assets in the ETF's underlying basket of assets instead of honouring redemption applications in cash. This would thus make it possible to prevent the management company selling its securities at excessively low prices when certain underlying assets become illiquid or difficult to value, without suspending subscriptions and redemptions. In the event of redemption in kind, the liquidity risks would thus be transferred to the AP and then, indirectly, to the secondary market, which should limit, including in normal times, the perception of increased liquidity on the secondary market in relation to the liquidity of the underlying assets.

The option of redeeming in kind would be open regardless of the replication method used by the ETF. Whatever the case, its application would remain the responsibility of the management company, which must continue to act solely in the interests of the unitholders or shareholders.

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or on a multilateral trading system and (as regards exchange-traded UCITS and RIFs) whose management objective may be based on an index.

[2] Unlike shares, ETF units or shares are not admitted for trading on a regulated market via a public offering. Instead, ETFs rely on a mechanism for creating and destroying units or shares that makes it possible to adjust the number of fund units or shares in circulation depending on demand. This creation/destruction process takes place once a day on the primary market and can be carried out only by a limited number of qualified entities known as authorized participants (APs) – generally major brokers or banks.

[3] Instruction 2011-19 related to approval procedures, establishment of KIID and a prospectus and regular reporting for French UCITS and foreign UCITS marketed in France and instruction 2011-20 related to approval procedures, establishment of KIID and a prospectus and regular reporting for retail investment funds, alternative funds of funds and retail professional funds.

[4] Article 3 of the model Regulations (Annex XV to AMF instructions 2011-19 and 2011-20) sets out the rules currently applicable to common funds.

[5] Article 8 of the model Articles of Incorporation (Annex XVI to AMF instructions 2011-19 and 2011-20) sets out the rules applicable to SICAVs and refers to the prospectus for communication to investors of the terms and conditions applicable to redemptions. Annex XIV to AMF instructions 2011-19 and 2011-20 (model prospectus) comprises developments concerning redemptions for ETFs but no details regarding redemptions in kind.

Question 1:
Are you aware of other conditions for redemption in kind already applied, particularly in Europe?

Question 2:
Does redemption in kind, as proposed, seem to you to be a useful liquidity management tool for ETF management companies?

2.2. Proposal 2: To put in place an action plan in the event of significant valuation or liquidity problems on the underlying-assets market, with a view to possibly suspending subscriptions and redemptions.

In the event of temporary suspension of the listing of part of the index's basket of representative securities, the management company uses other methods to calculate the end-of-day net asset value (NAV) as well, for example, as the valuation of the corresponding futures contract (when there are futures contracts on the underlying index) or indeed predictable (proxy) futures or other securities such as ADRs (American Depositary Receipts) or GDRs (Global Depositary Receipts).

When a sizeable portion of the securities of the replicated index has had their listing suspended or the other instruments mentioned are unavailable, their valuation may sometimes be approximate, which may in turn lead to a very approximate calculation of the NAV itself, meaning that holders cannot be treated fairly.

There is thus a proposal to modify AMF position-recommendation 2011-25, '*Guide to monitoring CIUs*', inserting a new part 7 devoted to the specific monitoring of ETFs, having the following recommendation added:[6]

7. Monitoring of ETFs: notification of the AMF in the event of a liquidity problem on the underlying market

Recommendation
If the weighting of the suspended underlyings represents more than 10% of the index monitored, it is recommended that the management company inform the AMF as soon as possible of its action plan and justifies its decision, documented as regards the liquidity conditions or the underlying markets, to suspend or to continue honouring subscriptions and redemptions on the primary market, in the best interests of the holders.

Questions 3 & 4:
Does this recommendation aimed at notifying the AMF in the event of difficulty on the market seem to you likely to limit the risks associated with the difficulty in valuing or in ensuring fair treatment for all the holders?
Do you think that the proposed 10% threshold is adequate?

Question 5:
Do you think it would be desirable to go further, recommending suspension of subscriptions and redemptions on the primary market, if a certain threshold of securities is reached (and not simple notification of the AMF)?

Question 6:
Would suspension of the exchanges of an ETF's listed units or shares (by a suspension of the listing or cessation of the supply of liquidity by APs), if a threshold of the underlying index's suspended securities is reached, make it possible to further limit risks?

[6] Details of the proposed new part are presented in Annex III.

2.3. Proposal 3: To draw up a continuity action plan in the event of default or event affecting a counterparty.

For ETFs exposed to counterparty risk (both in a lending/borrowing context and in the context of using financial futures), the AMF wishes to recommend that management companies become operationally prepared for a counterparty's default and detail the continuity plan envisaged in the company's programme of activity.

In the event of default or problem with a counterparty, the impact may be more or less significant depending on the ETF's management technique and the proposal in which the ETF has recourse to the lending/borrowing of securities or indeed to financial futures in the context of its replication.

To reduce as far as possible the lag time following the default of a counterparty, the AMF wishes to recommend that management companies become prepared for such a situation by having drawn up an action plan settling out the various options making it possible to continue replication of the index in the best interests of the holders. By way of example, for indirect replication ETFs, counterparty risks are generally low since financial contracts are regularly reinitialised (for UCITS, the counterparty risk may not exceed 10% on any issuer) but the default of the counterparty of a total return swap may prevent the ETF from replicating its index.

This recommendation would concern both the recourse to stock lending/borrowing and to financial futures or any other technique for efficient management of the portfolio.

There is a proposal to modify AMF position-recommendation 2012-19, '*Guide for drawing up the programme of activity of portfolio management companies*', inserting the following text:[7]

Recommendation
In the context of managing ETFs, when the fund has recourse to techniques for efficient management of the portfolio or OTC derivative contracts, it is recommended that the portfolio management company has drawn up an action plan including the various options being offered in terms of managing the ETF in the event of default of one or more counterparties, in the best interests of the holders.

Questions 7 & 8:
Do ETF management companies have to have active framework agreements with at least two counterparties for each transaction (without, however, undertaking to go as far as drafting the confirmation, which can be done when the parties intend to conclude a transaction)?
What would be the (human and financial) costs associated with systematically signing two framework contracts for one and the same transaction, with two different counterparties?

Question 9:
Do management companies deal with events affecting the counterparty's ability to provide the expected performance, and how can they respond to these events?

[7] Details of the proposed new part are presented in Annex IV.

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Annex I: Elements of the current policy concerning redemption in kind

Redemption in kind is currently authorised in France for the following common funds, under certain conditions:

UCITS and AIFs Article 3 of the model Regulations of funds (Annex XV to instructions 2011-19 and 2011-20) specifies that 'Redemptions are conducted exclusively in cash, except in the event of the fund's liquidation when unitholders have given their agreement to be redeemed in securities.' The maximum settlement period is five days, except in exceptional circumstances, when it may be extended to 30 days, the time needed to realise assets.

The model Articles of Incorporation of SICAVs (Annex XVI to instructions 2011-19 and 2011-20) do not specify anything concerning the redemption of shares, in kind or in cash. On the other hand, the model prospectus of SICAVs (Annex XIV to instructions 2011-19 and 2011-20) comprises the following provisions on redemptions for ETFs, which do not deal with redemptions in kind:

> Instruction 2011-19, Annex XIV (page 12)
> *'f) for a UCITS whose management objective is based on an index and whose units or shares are admitted for trading on a regulated market:*
>
> *- the fund's subscription and redemption conditions on the primary market*
>
> *- admission and trading of the fund's units on the secondary market.*
> *In accordance with position 2013-06, when the management objective of the UCITS is based on an index and the units or shares of this UCITS are admitted for trading on a regulated market, these units or shares acquired on a secondary market may not generally be redeemed at fund level. The fund's prospectus and marketing notifications must include the following warning: 'The units or shares of the listed UCITS ('ETF UCITS') acquired on the secondary market may not generally be sold directly to the listed UCITS. Investors must buy and sell units/shares on a secondary market with the assistance of an intermediary (e.g. broker) and may thus incur costs. Furthermore, it is possible for investors to pay more than the current net asset value when they buy units/shares and receive less than the current net asset value when they sell.'*
> *If the circumstances described in position 2013-06 have to be met, a UCITS whose management objective is based on an index and whose units or shares are admitted for trading on a regulated market must state in its prospectus the procedure to be followed by investors who have bought their units/shares on the secondary market, as well as any associated costs.*'
>
> Instruction 2011-20, Annex XIV (page 14)
> *'g) for an AIF whose management objective is based on an index and whose units or shares are admitted for trading on a regulated market:*
>
> *- the fund's subscription and redemption conditions on the primary market*
>
> *- admission and trading of the fund's units on the secondary market*'

Annex II: Proposed modification of the policy concerning redemption in kind

It is proposed that article 3 of the model Regulations of funds (Annex XV to instructions 2011-19 and 2011-20) be modified as follows (new text inserted in bold):

Article 3 – Issuance and redemption of units

Units are issued at any time at the request of the holders on the basis of the net asset value increased, as the case may be, by subscription fees.
Redemptions and subscriptions are conducted under the terms and conditions defined in the prospectus.
Common fund units may be admitted for listing in accordance with the regulations in force.

Subscriptions must be fully paid up on the day of calculation of the net asset value. Subscriptions may be conducted in cash and/or by contribution of financial instruments. The management company has the right to refuse the proposed securities and, to this end, has seven days from their deposit to make its decision known. In the event of acceptance, the securities contributed are valued in accordance with the rules set out in article 4 and subscription is conducted on the basis of the first net asset value following acceptance of the securities in question.
Redemptions are conducted exclusively in cash, except in the event of the fund's liquidation when unitholders have given their agreement to be redeemed in securities. ***When the fund is an ETF,[8] redemptions on the primary market may exceptionally be conducted in kind except in the event of the fund's liquidation, under conditions defined in agreement with the holders.*** *Redemptions are settled by the issuer account holder within a maximum period of five days in accordance with the period for valuing the unit.*

There is also a proposal to modify article 8 of the model Articles of Incorporation of SICAVs (Annex XVI to instructions 2011-19 and 2011-20) as follows:

Article 8 – Issuances, redemptions of shares

Optional text
When the fund is an ETF,[11] redemptions on the primary market may exceptionally be conducted in kind except in the event of the fund's liquidation, under conditions defined in agreement with the shareholders.

[8] In accordance with articles (i)(*a*) L. 214-7, paragraph 4, L. 214-8, paragraph 2 and I (listed UCITS) and II (exchange-traded UCITS) of article D. 214-22-1 of the Monetary and Financial Code (***MFC***), (*b*) L. 214-24-29, paragraph 4, L. 214-24-34, paragraph 2 and I (listed retail investment funds (***RIFs***), excluding dedicated RIFs referred to in article L. 214-26-1) and II (exchange-traded RIFs) of article D. 214-32-31 of the MFC, (*c*) L. 214-139, R. 214-183 and R. 214-183-1 of the MFC (listed alternative funds of funds (***AFFs***)) and (*d*) L. 214-143, R. 214-187 and R. 214-187-1 of the MFC (listed retail professional funds (***RPFs***)) and (ii) 411-134 (exchange-traded UCITS) and 421-72-1 (listed RIFs, AFFs and RPFs) and 421-27-2 (exchange-traded 'AIFs') of the AMF General Regulation (***AMFGR***), these ETFs are collective investment undertakings whose shares or units can be admitted for trading on a regulated financial instruments market or on a multilateral trading system and (as regards exchange-traded UCITS and RIFs) whose management objective may be based on an index.

Annex III: Proposed modification of AMF position-recommendation 2011-25, *'Guide to monitoring CIUs'*.

There is a proposal to modify AMF position-recommendation 2011-25, *'Guide to monitoring CIUs'* by inserting a part 7 drafted as follows:

7. Monitoring of ETFs:[9] *notification of the AMF in the event of a liquidity problem on the underlying market*

Recommendation

If the weighting of the suspended underlyings represents more than 10% of the index monitored, it is recommended that the management company inform the AMF as soon as possible of its action plan and justifies its decision, documented as regards the liquidity conditions or the underlying markets, to suspend or to continue honouring subscriptions and redemptions on the primary market.

[9] In accordance with articles (i)(*a*) L. 214-7, paragraph 4, L. 214-8, paragraph 2 and I (listed UCITS) and II (exchange-traded UCITS) of article D. 214-22-1 of the Monetary and Financial Code (***MFC***), (*b*) L. 214-24-29, paragraph 4, L. 214-24-34, paragraph 2 and I (listed retail investment funds (***RIFs***), excluding dedicated RIFs referred to in article L. 214-26-1) and II (exchange-traded RIFs) of article D. 214-32-31 of the MFC, (*c*) L. 214-139, R. 214-183 and R. 214-183-1 of the MFC (listed alternative funds of funds (***AFFs***)) and (*d*) L. 214-143, R. 214-187 and R. 214-187-1 of the MFC (listed retail professional funds (***RPFs***)) and (ii) 411-134 (exchange-traded UCITS) and 421-72-1 (listed RIFs, AFFs and RPFs) and 421-27-2 (exchange-traded 'AIFs') of the AMF General Regulation (***AMFGR***), these ETFs are collective investment undertakings whose shares or units can be admitted for trading on a regulated financial instruments market or on a multilateral trading system and (as regards exchange-traded UCITS and RIFs) whose management objective may be based on an index.

Annex IV: Proposed modification of AMF position-recommendation 2012-19, '*Guide for drawing up the programme of activity of portfolio management companies*'.

There is a proposal to modify AMF position-recommendation 2012-19, '***Guide for drawing up the programme of activity of portfolio management companies***' by inserting a 'Focus on ETFs' drafted as follows, as has been done for other financial instruments, but this time in part '*3.2.5. Best execution/selection policy'*:

3.2.5. Best execution/selection policy

[…]

Focus on ETFs

<u>Recommendation</u>

In the context of managing ETFs,[10] when the fund has recourse to techniques for efficient management of the portfolio or OTC derivative contracts, the portfolio management company must have drawn up an action plan including the various options being offered in terms of managing the ETF in the event of default of one or more counterparties, in the best interests of the holders. This action plan must be detailed in the management company's programme of activity.

[10] In accordance with articles (i)(*a*) L. 214-7, paragraph 4, L. 214-8, paragraph 2 and I (listed UCITS) and II (exchange-traded UCITS) of article D. 214-22-1 of the Monetary and Financial Code (***MFC***), (*b*) L. 214-24-29, paragraph 4, L. 214-24-34, paragraph 2 and I (listed retail investment funds (***RIFs***), excluding dedicated RIFs referred to in article L. 214-26-1) and II (exchange-traded RIFs) of article D. 214-32-31 of the MFC, (*c*) L. 214-139, R. 214-183 and R. 214-183-1 of the MFC (listed alternative funds of funds (***AFFs***)) and (*d*) L. 214-143, R. 214-187 and R. 214-187-1 of the MFC (listed retail professional funds (***RPFs***)) and (ii) 411-134 (exchange-traded UCITS) and 421-72-1 (listed RIFs, AFFs and RPFs) and 421-27-2 (exchange-traded 'AIFs') of the AMF General Regulation (***AMFGR***), these ETFs are collective investment undertakings whose shares or units can be admitted for trading on a regulated financial instruments market or on a multilateral trading system and (as regards exchange-traded UCITS and RIFs) whose management objective may be based on an index.