

Paris, 17 July 2007

Extra-financial criteria for securities selection: funds declaring themselves compliant with Islamic law

Collective investment schemes (CISs) may rely on criteria other than financial ones when choosing the securities in which they invest. They can also set special rules on income distribution.

In such cases, the AMF examines authorisation applications from CISs under its jurisdiction on the basis of rules that it has so far applied – in a conventional manner – both to CISs using strategies with extra-financial criteria, such as socially responsible investing or sustainable development, and to so-called shared-return funds, which distribute a portion of their income to entities other than investors.

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

I. Conditions for using extra-financial criteria and income sharing rules

1. Extra-financial criteria

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

- Preserving the autonomy of the asset management company (Art. 322-31 *et seq.* of the AMF General Regulation). This means, for example, that securities may not be chosen by an entity other than the company in charge of the financial management of the CIS. By contrast, a separate entity may give an opinion on the securities chosen by the asset management company, that extra-financial criteria are applied to the instruments preselected by the company.
- The involvement of a third party does not relieve the asset management company of its duty to put in place the resources needed to carry on its business (Art. 322-12 *et seq.* of the AMF General Regulation). This assumes, for example, that the asset management company is able to assess the extra-financial criteria it has defined.
- The selected extra-financial criteria must comply with all prevailing regulatory and statutory requirements. For example, criteria based on the race or religion of the managers of the companies invested in by the CIS are inadmissible because they violate public policy principles.
- Where the CIS uses a strategy described as an index-linked or index strategy and applies the risk-spreading rules applicable to this type of scheme, the index in question must satisfy the requirements of Article R. 214-28 II of the Monetary and Financial Code regarding diversification, representativeness and security. In this case, the role of the organisation that compiles the index is taken into account when assessing the autonomy of the management company.

2. Partial or full distribution of income

A CIS may distribute some or all of its distributable income to entities that are separate from its unitholders or shareholders, on condition that the following requirements are met:

- this option must be stated in the scheme's prospectus;
- the beneficiary must be a charitable organisation and cited in the full prospectus.

For French resident investors, this waiver of income can be considered as a donation that attracts tax relief. Unless they surrender this right, investors must be able to obtain a tax receipt from the beneficiary based on the information provided by the asset management company as to the identity of the donors and the amounts donated by each of them.

II. Application to CISs declaring compliance with Islamic law: a case study

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

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

- It replicates an index published by an independent supplier and obtained by screening the components of a broad global equity index using the extra-financial investment rules described below. These rules, established by a supervisory committee composed of prominent religious figures, have been published. The fund's strategy basically consists in investing in the stocks making up the index.
- The securities selection criteria adopted by both the index supplier and the fund so as to guarantee compliance with Islamic law are objective and have been made public. They pertain to sectors of activity and apply to certain financial ratios. For example, companies that rely on the alcohol and tobacco industries or pork-related products, etc., for their business and income are excluded. Other exclusions, still by way of example, concern companies with total balance sheet debt that exceeds 33% of their average market capitalisation over the previous twelve months.
- The autonomy of the asset management company is preserved. The company appoints a supervisory committee to advise the fund manager on Shari'ah-related issues. When examining the authorisation request, the AMF made sure that the actions of the supervisory committee did not compromise the independence of the asset management company and that the committee confined itself to giving an *ex post* opinion on the securities already chosen by the manager.
- A portion of the income is paid out to a charitable organisation. A maximum of 10% of the fund's income, corresponding to the percentage of the dividends considered as "impure" under Shari'ah, may be paid to a pre-designated French charity. The fund prospectus states that this donation attracts tax relief for investors resident in France, who must make themselves known to the asset management company in order to benefit from this provision.