

AMF Instruction
Risk management organisation for collective investment undertaking management activities and discretionary portfolio management investment services – DOC-2012-01

References: Articles 313-53-2 to 313-60, 318-38 to 318-43 and 314-3-2 of the AMF General Regulation

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1. General provisions

Article 1 - Scope of application

This Instruction applies:

- to collective investment undertaking management activities;¹
- and to discretionary portfolio management investment services, whether those services are provided by an asset management company or by an investment services provider other than an asset management company.

More particularly, this Instruction concerns the risks referred to in Article 313-53-3 of the AMF General Regulation or in Article 40 (2) of Commission Delegated Regulation (EU) n° 231/2013 of 19 December 2012,² meaning counterparty, liquidity and market risks, and operational risk insofar as it might have an impact on investment management.

2. Permanent risk management function

Article 2 - Permanent risk management function

In accordance with Article 313-53-4 of the AMF General Regulation or Article 39 of Commission Delegated Regulation (UE) n° 231/2013 of 19 December 2012,³ the Investment services provider shall establish and maintain a permanent risk management function.

¹ In accordance with Article L. 214-1 of the Monetary and Financial Code, collective investment undertakings include UCITS, AIFs and "other collective investment undertakings".

² For those persons referred to in Article 316-2 of the AMF General Regulation, for their AIF management activity.

³ For those persons referred to in Article 316-2 of the AMF General Regulation, for their AIF management activity.

The permanent risk management function shall have the necessary human and technical resources to conduct its risk management activities efficiently. In particular, it shall have knowledge, professional expertise, systems and techniques that are adequate to the complexity of the strategy and instruments used in the collective investment undertakings or discretionary portfolios under its management.

Article 3 - Independence of the permanent risk management function

1. – In accordance with the provisions of Article 313-53-4 or Article 318-38⁴ of the AMF General Regulation, the permanent risk management function shall be hierarchically and functionally independent from operating units in the following cases:

1. Where the management strategies applied in the collective investment undertakings or discretionary portfolios, or the risk measurement techniques of these strategies, may be considered 'complex'.

For example, an investment services provider must have an independent permanent risk management function if it implements any of the following strategies:

- option strategies (e.g. strategies that are delta-neutral or based on implicit volatility);
- marked non-directional arbitrage strategies;
- long/short or market-neutral strategies presenting high basis risk (risk of imperfect correlation caused by similar but not identical positions being taken in an opposite direction);
- strategies that sell credit protection.

As an exception to the above, long/short or market-neutral strategies can be considered 'simple' if both the following conditions are met:

- gross fund exposure does not exceed 200% of net assets (and commitment calculation does not allow offset or cover of certain positions⁵); and
- the fund uses only derivatives and simple securities involving derivatives, and operates only in the areas of 'traditional' risk and markets.

2. Where the investment services provider uses any of the following in its collective investment or discretionary portfolio management:

a) non-standard derivatives as defined in Instruction n° 2011-15 on global exposure for authorised UCITS and AIFs;

b) eligible financial securities and money market instruments with embedded derivatives, as referred to in Article R. 214-15-2 or Article R. 214-32-24-1 of the Monetary and Financial Code, where those derivatives are non-standard;

c) financial instruments posing particular valuation and/or liquidity difficulties (for example, contingent convertible bonds, commonly known as "CoCos"⁶);

d) financial instruments with material exposure to markets or risks other than traditional markets or risks (equity, interest rate, monetary, currency, bond, financial index⁷, inflation, credit), such as financial instruments whose performance is based on commodity, volatility, correlation or dividend markets or risks.

⁴ For those persons referred to in Article 316-2 of the AMF General Regulation, for their AIF management activity.

⁵ Method of calculating general risk described in AMF Instruction 2011-15. This involves calculation of the leverage generated by the use of derivatives, effective portfolio management techniques and financial securities involving a derivative. The commitment is generally used when the fund uses strategies and financial instruments that can be termed 'simple'.

⁶ The term "CoCos" (short for "contingent convertibles" or "compulsory convertibles") is used here to refer to subordinated debt securities issued by credit institutions or insurance or reinsurance companies that are eligible in their regulatory capital and are unique in that they can be converted into shares or written down in the event of a predefined trigger occurring, as specified in the prospectus for the said debt securities.

⁷ Financial indices here are the indices commonly recognised as being representative of a financial marketplace, geographic zone or particular sector.

Market or credit risk intervention must be examined carefully to determine whether it requires approval for 'derivatives and complex financial securities involving a derivative' or particular human and organisational resources. For example, single-name CDSs or CDS indices (iTraxx type), so long as standardised, may be classified as derivatives and simple financial securities involving a derivative, but basket-default swaps (n-to-default type) come under the heading of derivatives and financial securities that involve a derivative when they are complex.

3. Where the asset management company uses the value at risk calculation method referred to in Article 411-77 or Article 422-56 of the AMF General Regulation to measure global risk.

II. - Investment services providers may derogate from the provisions of Article 313-53-4 or Article 318-38⁸ of the AMF General Regulation where such a derogation is appropriate and proportionate in view of the nature, scale, diversity and complexity of its business and of the collective investment undertakings or individual portfolios it manages. In such cases, the permanent risk management function shall not be required to be hierarchically and functionally independent from operating units when the investment services provider:

- only provides the discretionary portfolio management investment service to professional clients or eligible counterparties, or;
- only manages collective investment undertakings open to professional investors (such as general purpose professional funds, specialised professional funds, professional private equity funds, professional real-estate investment schemes or equivalent foreign collective investment undertakings).

3. Delegation to a third party

Article 4 - Third party delegation arrangements

Where investment services providers delegate the conduct of risk management activities to a third party, pursuant to Article 314-3-2 of the AMF General Regulation,⁹ they shall comply with the following principles, among others:

1. Delegation to a third party must not cause any conflicts of interest, must comply with all the requirements concerning the permanent risk management function referred to in Article 313-53-4 above or in Article 39 of Commission Delegated Regulation (EU) n° 231/2013 of 19 December 2012¹⁰ and must not detract from the quality of the risk management system;
2. The investment services provider remains responsible for those activities delegated to that third party;
3. The investment services provider conducts due diligence to ensure that the third party has an adequate organisation and the necessary human and technical resources to perform the tasks that will be delegated to it in compliance with the regulations;
4. The investment services provider must be able to conduct adequate and ongoing supervision of the way in which the third party performs the activities delegated to it;
5. Where risk management activities delegated to a third party are no longer performed adequately, the investment services provider must take appropriate measures. It must be able to terminate its contract with the external service provider if necessary, without detracting from the continuity and quality of its activity. The investment services provider must take the necessary measures to ensure

⁸ For those persons referred to in Article 316-2 of the AMF General Regulation, for their AIF management activity.

⁹ Or Article 318-58 of the AMF General Regulation for those persons referred to in Article 316-2 of the AMF General Regulation for their AIF management activity. In such cases, it shall also comply with those other requirements set out in Article 318-58 and not already referred to in Article 4 of this Instruction.

¹⁰ For those persons referred to in Article 316-2 of the AMF General Regulation, for their AIF management activity.

the continuity of its risk management policy and procedures in the event of termination of its agreement with the third party;

6. Delegation to a third party must not compromise the ability of the AMF to monitor the adequacy of the risk management policy and procedures, and compliance by the investment services provider with its obligations.

In order to ensure that the third party has the necessary skills and capabilities to carry on its risk management activity reliably, professionally and effectively, in accordance with the provisions of Article 314-3-2 of the AMF General Regulation, the investment services provider shall maintain the resources and expertise necessary to effectively supervise the tasks or functions delegated to third parties and the services and provisions supplied.

4. Risk management policy and procedures

Article 5 - Risk measurement and management

I. Pursuant to Article 313-53-7 (l) a) or the first paragraph of Article 318-40¹¹ of the AMF General Regulation, the investment services provider shall adopt procedures in order to measure the risks to which the collective investment undertakings and individual portfolios it manages are exposed or likely to be exposed. If individual portfolios under its management are identical in terms of risk profile and composition of their assets, the risk management policy and procedures can be applied by family of portfolio. The investment services provider is responsible for conducting the analysis, which it must be able to justify at any time.

The permanent risk management function is in charge of implementing the risk measurement techniques defined in the risk management procedures, although those techniques may be executed partly by the operational functions, where appropriate.

For example, the operational functions may define the risk indicators for use in monitoring positions, or tolerance thresholds, provided that these indicators are validated and monitored by the permanent risk management function.

A prior analysis is therefore conducted of the risk profile of the potential investment, and the investment services provider may not use any assets for which it is not capable of identifying, measuring and managing all the risks at all times.

For example, investment in financial instruments and financial securities involving derivatives must be subject to the prior diligence required to identify all the risks relating to the investment in question. Particular attention must be paid to those risks contained in the structured products with embedded derivatives (EMTN, certificates...) it is considering using and producing, where applicable, breaking the products down into simple financial instruments in order to isolate all the risks relating to the products in question. As such products often contain complex derivatives, before any investment decisions are made, a precise analysis should be performed of the characteristics of the products and their associated risks (implied volatility, leverage, presence of a barrier in exotic options, possible correlation risk in the event of indexing on baskets of assets, liquidity risk in the absence of a secondary market, risk relating to legal documentation...) to ensure that the products are compatible with the risk profile of the portfolios.

Likewise, when the investment services provider invests the collective investment undertakings or individual portfolios under its management in securitisation vehicles, it must conduct a prior analysis of the structure and composition of their assets to obtain an appropriate understanding of the risks incurred, and to check the adequacy of the investment to the risk profile of the portfolio and the investment constraints that go with it; although a rating awarded to the product may be one factor taken into account in this analysis process, it may in no place be a substitute for such a process.

¹¹ For those persons referred to in Article 316-2 of the AMF General Regulation, for their AIF management activity.

The investment services provider shall identify, measure, analyse and manage at all times the risks relating to the strategy it applies to the collective investment undertakings or individual portfolios under its management, including market, liquidity and counterparty risk, and exposure to any other risk, including issuer concentration risk.

II. To do so, and in accordance with Article 313-53-7 (II) of the AMF General Regulation or Article 45 (3) of Commission Delegated Regulation (UE) n° 231/2013 of 19 December 2012,¹² the investment services provider shall establish and implement, among other things:

1. risk mapping, taking account of the risks of each position of the collective investment undertaking or individual portfolio it manages, and the interaction between those individual risks;
2. relevant risk indicators and a system of risk limits that is consistent with the risk profile of the collective investment undertaking or individual portfolio under its management;
3. an alert generation mechanism to prevent and detect any breaches of the limits, and remedial procedures in the event of any actual or anticipated breaches of the limits.

¹² For those persons referred to in Article 316-2 of the AMF General Regulation, for their AIF management activity.

It updates them regularly to ensure their adequacy and efficiency.

Article 6 - Risk management policy supervision

In accordance with Article 313-53-6 of the AMF General Regulation or Article 41 of Commission Delegated Regulation (EU) n° 231/2013 of 19 December 2012,¹³ the investment services provider shall assess the adequacy and effectiveness of the risk management policy.

To this effect, and in accordance with Article 313-53-4 (III) of the AMF General Regulation and Article 39 of Commission Delegated Regulation (EU) n° 231/2013 of 19 December 2012,¹⁴ the permanent risk management function is in charge of ensuring compliance with the risk limit and supervision system at all times:

1. the risks relating to the collective investment undertakings or individual portfolios under its management and referred to in the last paragraph of Article 5 (I) of this Instruction are clearly identified and measured;
2. the risk mapping, risk indicators and risk limit system comply with the requirements referred to in Article 5 (II);
3. if the limits should be breached, prompt and appropriate remedial measures are taken to correct the portfolios.

Article 7 - Risk measurement techniques and systems

Pursuant to Articles 313-53-4 and 313-53-7 of the AMF General Regulation or Article 39 of Commission Delegated Regulation (EU) n° 231/2013 of 19 December 2012,¹⁵ the permanent risk management function implements risk management procedures and validates the risk measurement techniques defined in these procedures:

1. It checks that the theoretical foundations are relevant and that the assumptions used are adequate to the characteristics of the investments and the management strategy applied;
2. It checks that the parameters used are reliable, robust and adequate to the management strategies used and to market behaviour, and that the market data used is fed in properly;
3. It approves the range of validity and limits of each risk measurement technique or tool, notably as regards the specifics of the management strategy applied, assets used and particular market conditions;
4. It checks the proper IT implementation of each risk measurement technique or tool.

Article 8 - Risk measurement

Pursuant to Article 313-53-7, I, a) or Article 318-40¹⁶ of the AMF General Regulation, for the purposes of effective risk measurement, the investment services provider takes account of market conditions and possible changes to these conditions that are likely to modify the risk profile of the investments or the strategy of the collective investment undertaking or individual portfolios.

It shall take account of the results of the stress tests and scenario analyses designed for this purpose.

¹³ For those persons referred to in Article 316-2 of the AMF General Regulation, for their AIF management activity.

¹⁴ For those persons referred to in Article 316-2 of the AMF General Regulation, for their AIF management activity.

¹⁵ For those persons referred to in Article 316-2 of the AMF General Regulation, for their AIF management activity.

¹⁶ For those persons referred to in Article 316-2 of the AMF General Regulation, for their AIF management activity.

In particular, it shall perform simulations and stress tests to assess the liquidity risk to which the collective investment undertakings and individual portfolios are exposed. It takes account of these results in the implementation of the liquidity risk management procedure referred to Article 313-53-7 (III) of the AMF General Regulation or Article 40 (3) b) of Commission Delegated Regulation (UE) n° 231/2013 of 19 December 2012.¹⁷

Counterparty risk management includes all the diligence necessary to measure the creditworthiness of the counterparty and to ensure that counterparty risk is controlled at all times. It takes account of the concentration of investments having entities belonging to the same group as their counterparty.

Article 9 - Risk management and financial instrument valuation

In accordance with the provisions of Article 313-53-4 (III) f) of the AMF General Regulation or Article 70 of Commission Delegated Regulation (EU) n° 231/2013 of 19 December 2012 the permanent risk management function reviews and enhances the OTC derivative valuation systems and procedures.¹⁸

The permanent risk management function validates and conducts regular reviews of the valuation process for the assets mentioned above, in view of their complexity, and of the valuation models used by the investment services provider. This validation covers the theoretical foundations, IT implementation and choice of the parameters in the models and the market data used.

The investment services provider shall make provision for the measures necessary in the event of a mismatch between the valuation of the abovementioned assets by the investment services provider and the prices provided by counterparties or external contributors. These measures shall include notably an independent second valuation of the assets by the permanent risk management function.

Article 10 - Measurement of the global risk of authorised UCITS and AIF by the value at risk calculation method

Where the asset management company uses the value at risk calculation method to measure the global risk of an authorised UCITS or AIF,¹⁹ the permanent risk management function shall ensure compliance with the global risk limits in accordance with Article 313-53-7 (I) b) of the AMF General Regulation or Article 45 (1) b) of Commission Delegated Regulation (EU) n° 231/2013 of 19 December 2012.²⁰ To this effect, the permanent risk management function shall fulfil the following requirements:

1. It shall give its validation before and after any material change to the value at risk model and ensure that it is adequate to the portfolio of the authorised UCITS or AIF at all times. It shall validate the calibration of the model and the back-testing systems;

The following shall be considered to be material changes to the value at risk model:

- the introduction of a new type of financial asset into the portfolio of the authorised UCITS or AIF;
- any change made to the value at risk model further to back testing;
- any decision by the asset management company to make a significant modification to certain aspects of the model.

2. It feeds, tests, maintains and uses the value at risk model daily;

3. Where the asset management company adopts the value at risk calculation method to measure the global risk of an authorised UCITS or AIF, it shall supervise the procedure for determining the reference portfolio referred to in Article 411-78 or Article 422-57 of the AMF General Regulation;

¹⁷ For those persons referred to in Article 316-2 of the AMF General Regulation, for their AIF management activity.

¹⁸ And more generally of the assets for those persons referred to in Article 316-2 of the AMF General Regulation, for their AIF management activity.

¹⁹ See also Instruction n° 2011-15 on the calculation of global exposure for authorised UCITS and AIFs.

²⁰ For those persons referred to in Article 316-2 of the AMF General Regulation, for their AIF management activity.

4. For each authorised UCITS or AIF, it validates and implements a system of value at risk limits that is consistent with its risk profile, and checks this limit system regularly;
5. It supervises the leverage level of the authorised UCITS or AIF regularly;
6. It produces regular reports for its governing bodies indicating the current level of value at risk (including the levels measured by back testing and stress testing).

The value at risk model documentation must include:

- a) The operating principles of the value at risk models, providing details of the measurement, including the risks covered by the model, the methodology, the mathematical assumptions and foundations, the data used, the accuracy and completeness of the risk assessment, the methods used to validate the model, the validity range of the models and their operational implementation;
- b) The back testing process;
- c) The stress testing process.

5. Documentation of the risk management policy

Article 11 - Documentation and filing

In accordance with Article 313-53-5 (l) of the AMF General Regulation or Article 40 (1) of Commission Delegated Regulation (E) n° 231/2013 of 19 December 2012,²¹ the investment services provider shall draw up detailed, regularly-updated documentation of the risk management policy, including all the procedures.

This documentation shall concern notably the following points:

- the risk mapping, risk indicators, risk limit system and remedial measures in the event of breaches;
- the operating principles of the risk measurement techniques and tools used, their range of validity, the updating frequency and procedures for the parameters used and the procedures for ex ante and ex post validation of techniques;
- the interaction between the permanent risk management function and the operating teams, notably the management team.

Whenever a modification is made, the documentation must be updated.

²¹ For those persons referred to in Article 316-2 of the AMF General Regulation, for their AIF management activity.