

The Brief

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Editorial

French UCITS and Derivatives: A new Decree on financial transactions

On Saturday November 22, 2003 was published the long awaited Decree no. 2003-1103 modifying Decree no. 89-623 dated September 6, 1989 implementing the law no. 88-1201 of December 23, 1988 relating to French UCITS, i.e. *organismes de placement collectif en valeurs mobilières* ("OPCVMs").

The Decree implements an in depth reform of the existing legal environment applicable to eligible investments and assets and to the capacity of OPCVMs to trade derivatives (including credit derivatives), repo and securities lending transactions.

As a matter of clarification, most of Decree no. 89-624 dated September 6, 1989, which contained most of the rules previously applicable to such financial transactions has been abrogated, also last Saturday, by Decree no. 2003-1104.

You will find below a free English translation of Section 2 of Decree no. 2003-1103 which relates to "Rules applicable to derivatives and temporary transfers".

The highly debated issue of OPCVMs' capacity to post **collateral** seems to be addressed, in passing, by the Decree which, when addressing ratios applicable to collateralised repos requests that purchased securities are not then "*transferred as collateral*". It is regretful that such a key issue, which was clearly addressed in the preceding drafts circulated by the Government, has been somehow left out of the final version of the Decree. No need to say that an urgent clarification of that issue by the AMF would be greatly appreciated by the market.



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General conditions applicable to general purpose OPCVMs when entering into OTC financial derivatives are the following:-

- its constitutive documents, i.e. Regulations / Statutes, Information Memorandum and investment policies or guidelines, must expressly provide for such capacity (standard AMF or market wordings existing);
- it can only trade with a counterparty licensed to perform investment services in France and being either (i) an EU UCITS's depository, (ii) a credit institution duly incorporated in an OECD member state, or (iii) an investment firm duly incorporated in an EEA member state whose stockholder's equity, within the meaning of EU Directive 2000/12/CE dated March 20, 2000, is at least equal to €3,800,000;
- its net exposure to one counterparty, in respect of derivatives, taking into account eligible collateral received, must not exceed 10% of its assets;
- its aggregate commitment in respect of derivatives, as defined by the Decree, shall not exceed, at any time, 100% (one hundred percent) of its assets;
- the transactions must only be entered into for hedging its assets **or** achieving its "management objective";
- it must have the right to terminate any transaction, at any time, at a pre-determined or market value;
- the transactions must be governed by a market master netting agreement, in the meaning of Article L.431-7 of the French monetary and financial Code;
- save in the case of certain equity index transactions, the underlying of each transaction shall be integrated in, and comply with, its investments and assets ratios;
- it must implement adequate procedures to manage, control, value and monitor these transactions; and

Supplemental conditions applicable to the trading of **credit derivatives** – as both protection buyer or seller - are the following:-

- the AMF must have approved its investment manager's "Specific activity program relating to the use of credit derivatives";
- its constitutive documents, must expressly provide for its capacity to enter into credit derivatives in a sufficient level of details;
- its aggregate commitment in respect of credit derivatives with a counterparty "linked" to its investment manager, as defined by the Decree, must not exceed 20% of the overall aggregate commitment of this OPCVM in respect of all its credit derivatives;

- the transaction should comply with the characteristics of credit derivatives as defined by market agreements referred to in Article L.431-7 of the French monetary and financial Code;
- "Reference Entities" can only be: a State, an international public organizations of which one or several Member States of the European community are members, a local authorities of the European community, a legal entity having issued debt instruments rated by an approved rating agencies and listed on an AMF recognized regulated market (certain not listed debt instruments can however be assimilated to those), a legal entity whose stocks are listed on an AMF recognized regulated market, or several of the above entities;
- a physical settlement of the transaction should not lead the OPCVMs to receive any non eligible assets; and
- more generally, the terms of the transactions, e.g. "General Terms", "Obligation Category" and "Characteristics", "Reference Obligations", "Settlement Terms", "Deliverable Obligations", etc. must comply with the new AMF's policy statements on credit derivatives dated November 12, 2003.

As regards **temporary transfers**, an OPCVM can take sell and buy positions up to the respective limits of 100% and 10% of its assets. The latter can however be increased to 100% if the relevant repos are fully collateralised and that the purchased securities are not "*sold, even temporarily, or transferred as collateral*". Purchased assets shall be integrated in, and comply with, its investments and assets ratios. A number of conditions, similar to those listed above for derivatives, relating to eligible counterparties, proper documentation, right to terminate, ratios, etc. must also be complied with in respect of temporary transfers.

When a security consists in, or contains, a derivative, such derivative must be taken into account in the OPCVM ratios for forward financial instruments.

Please note, that ratios and rules listed above apply mainly to "general purpose" OPCVMs. Depending on the type of OPCVM concerned, some of them may therefore vary. As an illustration, the 10% maximum counterparty risk ratio does not apply to OPCVMs "*à règles d'investissement allèges à effet de levier*", the investment managers of which will have to file a specific activity program before December 31, 2004. Such OPCVMs will also have the possibility to leverage three times their assets.

In conclusion one should stress on the **general principal** expressed by Article 4.4 III of the Decree is that any use by an OPCVM of financial transactions such as exchange-traded or OTC derivatives, repos, securities lending or any similar temporary transfers, must not lead it to diverge from its investment objectives as described in the Information Memorandum distributed to its units or shares holders.

The Decree, which constitutes a considerable inflation of existing regulations, also aims at implementing in France a considerable amount of issues addressed by the EU UCITS III Directive of December 4, 2001.

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This memorandum is a summary of certain legislative reforms introduced in France. It is circulated for information purposes only and should not be used as the basis for any business or investment decision without prior specific legal assistance. For further explanation or additional information, please do not hesitate to contact the signatories.

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Section 2 of Decree no.2003-1002 dated November 21, 2003 Modifying Decree no.89-623 dated September 6, 1989

Section 2 Rules applicable to derivatives and temporary transfers

Article 4-4. – I. - For the purposes of this Decree, counterparty risk means the risk that such counterparty fails to fulfil one of its obligations and as a result causes the OPCVM to suffer a financial loss. The counterparty risk is equal to the marked to market value of the relevant agreements minus any guarantees constituted in favour of the OPCVM.

Counterparty risk of an OPCVM vis-à-vis one particular counterparty resulting from the agreements referred to in Articles 4-5 to 4-9 below must not exceed 10% of its assets.

Guarantees referred to in the first paragraph above may be reached in the form of deposits, pledge of financial instruments or account of financial instruments, title transfers in financial instruments or cash, securities lending or repurchase agreements, joint and several guarantees or first demand guarantees.

Guarantees referred to in the first paragraph above must be granted by an institution qualifying as an UCITS depository, a credit institution having its registered office in an OECD Member State or an investment firm having its registered office in a European Union Member State or a party to the European Economic Area and which is licensed to provide the service defined in Paragraph 1 of Article L.321-2 of the Monetary and financial code and whose stockholder's equity within the meaning of the EU Directive 2000/12/CE, is at least equal to €3.8 million.

When the guarantees are constituted by deposits, Paragraphs 2°, 3°, 4°, and 5° of Article 2-1 do not apply within the limit of the needs of the counterparty risk hedging.

II. - For the purposes of this Decree the aggregate commitment of an OPCVM in respect of forward financial instruments is comprised of the highest of the potential loss of the OPCVM at any time and the product of the leverage which such instruments provide to the OPCVM by the value of the assets of the OPCVM.

Leverage is defined as the ratio between such forward financial instruments' market value variations and the variations in the market value of their underlying, taking into account the contribution of such underlying assets to the portfolio risk profile. The underlying assets may be one or several financial instruments referred to in Paragraph 2° of Article 1, save (e) [*derivatives*], and one or several characteristics of such financial instruments.

III. - The use of forward financial instruments, repurchase transactions or any similar transactions for temporary transfers, by an OPCVM must not lead it must not lead it to diverge from its investment objectives as described in the information memorandum distributed to its units or shares holders.

Sub-Section 1
Derivatives

Article 4-5. – I. – An OPCVM may enter into contracts constituting forward financial instruments [*derivatives*] in order to hedge its assets or achieving its management objective, in accordance with the conditions set forth by Article 4-4 and the following two cumulative conditions :-

- 1° the commitment of the OPCVM on forward financial instruments must not exceed 100% of the value of its assets;
- 2° the contracts must have the following characteristics :
 - (a) they are traded on one of the regulated markets referred to in Article L. 214-42 of the Monetary and financial code; or
 - (b) they qualify as interest or exchange rates forwards traded on organized markets the rules of which define the operating, access and negotiations conditions, operating on a regular basis and having a clearing-house providing requirements for daily margining. The list of such organized markets is established by the Minister of the economy;
 - (c) they are not concluded on a market referred to in a) or b), but meet each of the following conditions:-
 - (i) the OPCVM can terminate them at any time, at a pre-determined or market value;
 - (ii) they are entered into with a counterparty having one of the status listed in Paragraph 4 of Article 4-4. – I; and
 - (iii) they are governed by a market master netting agreement, in the meaning of Article L.431-7 of the French monetary and financial Code.

II. - Save for forward financial instruments based on indexes fulfilling the conditions defined in Paragraph II of Article 16, the underlying investment of such contracts shall be taken into account for the application of the provisions of the first six Paragraphs of Article L. 214-4 of the Monetary and financial Code.

Article 4-6. An OPCVM may enter into forward financial instruments having the characteristics of credit derivatives as defined by the market master agreements referred to in Article L. 431-7 of the Monetary and financial Code, provided that the conditions listed in Articles 4-4 and 4-5 and the following additional ones are both met:-

- 1° the investment manager managing, directly or through a delegation, the relevant OPCVM must have obtained the prior approval of the AMF on its "specific activity program relating to the use of credit derivatives". Such program must, among other things, provide for the implementation of both systems and organization permitting:-
 - (a) a daily valuation by the investment manager of such instruments and an at least monthly comparison of such valuations with external sources;

- (b) a risks analysis, prepared by a department independent from the commercial and operational units and submitted, at least semi-annually, to the deliberating body of the investment manager in order to the setting of limits;
 - (c) an internal independent control process independent from operational functions.
- 2° the aggregate commitment resulting from such instruments when entered into with a counterparty linked to the investment manager, in the meaning of the last Paragraph of Article 10. – V of the Decree, must not exceed 20% of the overall aggregate commitment of this OPCVM in respect of credit derivatives;
- 3° issuers on which such instruments are based, may be:-
- (a) one or several States;
 - (b) one or several international public entities of which one or several EC Member States are members;
 - (c) one or several EC local authorities;
 - (d) one or several legal entities having issued at least:-
 - (i) debt securities having the characteristics listed in Paragraph II of Article 2 of the Decree or listed on a regulated market in the meaning of Paragraph I of Article 2 of the Decree, and having rendered public, for at least one issuance of such securities, at least one rating obtained from one of the rating agencies approved by the Minister of the economy; or
 - (ii) stocks listed on a regulated market in the meaning of Paragraph I of Article 2 of the Decree;
 - (e) several of the above mentioned entities.
- 4° The settlement of such instruments may only give rise to the delivery or transfer of eligible assets.

Article 4-7. When a financial instrument listed in Paragraphs (a), (b) or (d) of Article 1. 2° of the Decree consists in, or contains, a forward financial instrument, such latter instrument must be taken into account for the purposes of Articles 4-4, 4-5 and 4-6.

Sub-Section 2
Temporary Transfers

Article 4-8. – I. – An OPCVM may temporarily sell financial instruments, for up to 100% of its asset.

An OPCVM may temporarily purchase financial instruments, for up to 10% of its asset.

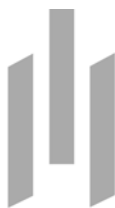
The liquidative value of an OPCVM's units or shares is determined by taking into account the market prices variations of securities so temporarily sold.

II. – To enter into transactions referred to in I above, an OPCVM must comply with each of the following conditions :-

- 1° such transactions are entered into with a counterparty referred to in Paragraph 4 of I of Article 4-4 ;
- 2° they are governed by a market master agreement referred to in Article L. 431-7 of the Monetary and Financial Code;
- 3° they must be taken into account for the application of the general composition rules of the assets, of the maximum investment ratio (*ratio d'emprise*), of the rules for counterparty risk and the commitment rules defined in this chapter;
- 4° they must comply with the settlement rules set out in Paragraph (c) of Article 4-5. I 2°.

Article 4-9. – Without prejudice to the provisions of Article 4-8. I, the limit referred to in Paragraph 2 of Article 4-8. I is raised to 100% when the OPCVM transfers cash as payment the purchased securities and such securities are not then sold, even temporarily, or transferred as collateral.

[...]



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