

## Central Bank of Ireland Review of Closet Indexing

The Central Bank of Ireland (“**Central Bank**”) has published its findings following its thematic review of Irish UCITS and closet indexing. The “Dear CEO” letter outlining the findings highlights the key supervisory issues identified and calls on UCITS fund management companies to actively consider the findings and review and revise fund documentation where necessary.

### Background

On 18 July 2019, the Central Bank published a Dear CEO letter addressed to the boards of UCITS and their managers following its data driven review of the 2,550 Irish authorised UCITS (including 15,500 share classes) classified as actively managed as at March 2018.

The Central Bank’s review follows up on supervisory work by the European Securities and Markets Authority (“**ESMA**”) seeking to identify closet indexing at an EU-wide level, outlined in its 2016 **statement**. ESMA defines closet indexing as the practice:

*“whereby asset managers claim, according to their fund rules and investor information documentation, to manage their funds in an active manner while the funds are, in fact, staying very close to a benchmark and therefore implementing an investment strategy which requires less input from the investment manager. At the same time, it is alleged that these funds charge management fees in line with those of funds that are considered to be actively managed.”*

The Central Bank announced in December 2018 that it was commencing its review of Irish UCITS classified as actively managed in order to determine if they are closet-trackers. A number of other European regulators have carried out similar reviews, including the UK Financial Conduct Authority, the Danish financial regulator and the Norwegian financial regulator. Earlier this year, ESMA also issued an updated version of its questions and answers document on the application of the UCITS Directive requiring new disclosures in the UCITS Key Investor Information Document (“**KIID**”) aimed at preventing closet indexing. The updates to KIIDS are required to be made “*as soon as practicable*” or by the next KIID update.

Using three analytical measures (Tracking Error Volatility,  $R^2$  and Beta<sup>1</sup>) in order to identify those UCITS that appear to be moving closely in line with an index, the Central Bank identified 182 UCITS

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<sup>1</sup> The letter explains these measures as follows: **Tracking Error Volatility (“TEV”)** – The TEV obtains the difference between the movement of the UCITS and the movement of the index and measures the volatility of that difference. UCITS with lower TEV are more likely to be potential indexing funds. **Beta** – The line of best fit between the movement of the UCITS and index is obtained using a linear regression. Analysis of the line of best fit is performed to see does the UCITS move in line with the index.  **$R^2$**  – Is also linked to the line of best fit,  $R^2$  is the variation in the UCITS explained by the variation of the index.

for further review. The Central Bank has reviewed the relevant documentation for each of these 182 UCITS and has completed specific follow up engagement with an initial group of 62 UCITS. The Central Bank will continue its engagement with the remaining UCITS over the coming months. The Central Bank will have regard to the contents of the letter as part of future supervisory engagement.

In the case of 57 of the 62 UCITS in the initial group, the Central Bank has identified that investors were not given sufficient or accurate information about the UCITS investment strategy in the prospectus or KIID. The Central Bank have provided a Risk Mitigation Programme to these UCITS, including a requirement that the UCITS revise its prospectus and KIID and send the revised documentation to investors. The communication with investors should confirm that it is being sent at the direction of the Central Bank and should include details of the Central Bank's findings which prompted the amendments to the fund documentation.

The key supervisory issues identified in the Central Bank's review are set out the Dear CEO letter, together with certain actions to be taken by UCITS to mitigate those issues.

## Key Findings

### Finding 1: Inadequate Disclosures in Prospectus and KIID

The Central Bank found that investors were not always given sufficient or accurate information about the UCITS' investment strategy in the prospectus and KIID to enable the investor to make an informed decision on whether to invest in the UCITS.

The Central Bank identified cases where:

- the disclosures in the prospectus and KIID did not accurately describe the true nature of the UCITS' investment strategy, such as whether the UCITS followed an active or passive investment strategy;
- there were inconsistencies between the information contained in the prospectus and KIID and other fund documentation such as marketing material;
- marketing material explained the investment strategy more clearly than the prospectus and the KIID but the marketing material was typically only made available to institutional investors, which potentially disadvantaged non-institutional investors; and
- there was a failure to disclose in the prospectus or KIID that the UCITS was operating in a risk-managed, constrained manner with risk limits in place that would limit the fund's ability to significantly deviate from the stated benchmark.

### Finding 2: Poor Governance and Controls by Boards of UCITS Management Companies

The cases of poor governance and controls by fund management company boards (the "**Board**") identified by the Central Bank included:

- insufficient review and oversight of fund offering documents;
- insufficient evidence of Board challenge regarding the chosen strategy of the UCITS;
- approving management fees in excess of the UCITS' targeted outperformance of the benchmark;

- insufficient oversight of the UCITS' distribution and investment strategy; and
- a lack of regular assessment by the Board to determine whether the performance of the UCITS is reflective of the expected active management that investors are paying for, and whether the fees charged are commensurate with the level of actual active management and performance achieved.

### **Finding 3: Multi-Manager Funds**

The Central Bank found cases where multi-manager UCITS consistently delivered a performance similar to an index, raising a question as to whether the diversification benefits of the multi-manager approach as compared to passive investing were being achieved by those funds over time. The Central Bank recommended that, where a UCITS is using a multi-manager approach, the Board should consider whether this results in a strong correlation with an index to the extent that charging active management fees may not be appropriate.

### **Finding 4: Management Fee Relative to Target Outperformance**

The Central Bank identified cases where UCITS have a target outperformance against a benchmark that is less than the fee charged to certain share classes in a UCITS, with the result that, even if the UCITS provides a return at the upper end of its projections, investors in these share classes will not realise a positive return against the benchmark, as the fee charged will cancel out any outperformance achieved.

### **Finding 5: Failure to Disclose Performance of a Relative Benchmark**

The Central Bank found instances where the past performance section of the KIID did not include relevant benchmark disclosure, meaning that investors were not able to determine from the KIID whether the UCITS represented good value relative to its benchmark.

### **Board Action Items**

1. The Dear CEO letter should be brought to the attention of all Board members and to the relevant responsible persons within the fund service providers and to designated persons.
2. Boards must actively consider the contents and findings of the Dear CEO letter as they carry out their role, and review and revise their prospectus and KIID where necessary.
3. When considering the accuracy of the content of its prospectus and KIID, the Board of each UCITS must ensure that:
  - (a) the prospectus and KIID are in compliance with all applicable legislative requirements and all relevant guidance. The Central Bank expressly states that this includes Q&As

issued by ESMA, which is consistent with recent Central Bank statements that the Q&As should not be disregarded on the basis that they have no legal standing as it is the Central Bank's view that compliance with the Q&As is a way of demonstrating compliance with the substantive regulatory requirements;

- (b) any marketing material or other information provided to investors is consistent with the information contained in the prospectus and KIID;
  - (c) if the fund is managed in a constrained manner to a benchmark, this constraint must be disclosed in the prospectus and KIID; and
  - (d) where the fund is managed with a performance target, this must be disclosed in the prospectus and KIID in order to assist investors in making an informed decision.
4. Any necessary updates to the prospectus and KIID must be submitted to the Central Bank by **31 March 2020**.
5. When assessing the investment manager's annual presentation, the Board must consider if the UCITS has delivered on the stated objective and remains a viable and suitable investment for investors. This review must be documented and should assess, inter alia, the UCITS performance, fee structure and investor base. The fees charged on all share classes within the UCITS should be reviewed to assess whether they are appropriate to for the targeted level of outperformance of the UCITS against its benchmark.

## Comment

The Central Bank's findings on ongoing supervisory engagement are indicative of ongoing regulatory scrutiny of closet tracking across Europe, which will continue over the coming months. Boards should carefully consider the Dear CEO letter and take appropriate action to ensure that the concerns raised by the Central Bank are fully addressed, including a review (and amendment, where necessary) of fund documentation and board procedures to ensure compliance.

In relation to the 31 March 2020 deadline referred to in the Dear CEO letter, to the extent that the changes to fund documentation reflect the amendments required by the ESMA UCITS Q&A, these changes may already have been made in an earlier KIID update and by the annual KIID review deadline in February 2020 at the latest. While we are aware of ongoing industry engagement with ESMA as to the implementation of the ESMA UCITS Q&A, and in particular whether the requirements relating to disclosures as to when an active fund is managed in reference to an index are unnecessarily broad, we consider it prudent to progress the action items set out above at this stage.

Please get in touch with your usual Asset Management and Investment Funds Department contact or any of the contacts listed in this publication should you require further information in relation to the material referred to in this update.

*Full details of the Asset Management and Investment Funds Department, together with further updates, articles and briefing notes written by members of the Asset Management and Investment Funds team, can be accessed at [www.matheson.com](http://www.matheson.com).*

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