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## Re: Thematic Review of Closet Indexing

Dear Chair,

The Central Bank of Ireland (the “Central Bank”) has undertaken a thematic review of Irish authorised Undertakings for Collective Investment in Transferable Securities (“UCITS”) on the subject of closet indexing<sup>1</sup> (the “Review”). The purpose of the Review was to identify instances where a UCITS described as actively managed is performing close to the performance of an index without proper disclosure to investors, including having regard to regulatory disclosure obligations for UCITS.<sup>2</sup>

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<sup>1</sup> Closet indexing has been described by the European Securities Markets Authority (“ESMA”) (ESMA statement of 2 February 2016 – ref ESMA/2016/165) as a 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 [and] charge management fees in line with those of funds that are considered to be actively managed.

<sup>2</sup> Including for example Regulation 89(1)(a) of S.I. No. 352 of 2011 - European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2011, which requires that “*the Prospectus shall include the information necessary for investors to be able to make an informed judgement of the investment proposed to them, and, in particular, of the risks attached thereto.*” And Article 7(1)(d) of Commission Regulation (EU) No 583/2010 which requires “The description contained in the ‘Objectives and investment policy’ section of the key investor information document shall cover those essential features of the UCITS about which an investor should be informed, even if these features do not form part of the description of objectives and investment policy in the prospectus, including: whether the UCITS allows for discretionary choices in regards to the particular investments that are to be made, and whether this approach includes or implies a reference to a benchmark and if so, which one.”



To complete this body of work, the Central Bank carried out its largest data driven review of the funds industry to date. Detailed analysis was carried out on all of the 2,550 Irish authorised UCITS funds classified as actively managed as at March 2018. These UCITS had a total of 15,500 share classes, which were individually analysed against a suite of over 2,500 indices using analytical parameters<sup>3</sup> of Tracking Error Volatility, R-squared and Beta, in order to identify those UCITS that appear to be closely moving in line with an index. Having regard to the ESMA description of closet indexing, the Central Bank data analysis identified 182 UCITS for further review. The Central Bank has reviewed the relevant documentation<sup>4</sup> for each of these 182 UCITS and commenced its follow up with UCITS on foot of our findings from this document review. To date the Central Bank has completed specific follow up engagements with an initial group of 62 UCITS and will continue its engagement with the remaining UCITS over the coming months.

The purpose of this letter is to highlight key supervisory issues identified from the Review and to set out certain actions to be taken by UCITS to mitigate these issues. In addition to the actions required by this letter, the Central Bank has commenced supervisory engagements with each of those individual UCITS where specific issues have been identified. This includes 57 of the 62 UCITS referred to above where the Central Bank has identified that investors were not given sufficient or accurate information about the UCITS' investment strategy in the Prospectus or Key Investor Information Document ("KIID"). The Central Bank will include in the Risk Mitigation Programme for these UCITS a requirement that the UCITS revise its Prospectus and KIID and send the revised documentation to all investors, together with details of the Central Bank's findings which prompted the amendments.

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<sup>3</sup>**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<sup>2</sup>** - Is also linked to the line of best fit, R<sup>2</sup> is the variation in the UCITS explained by the variation of the index.

<sup>4</sup> Prospectus & Supplement, KIID, annual accounts and Investment Management agreement



Key findings from the Review included:

1. Investors were not always given sufficient or accurate information about the UCITS's investment strategy in the Prospectus and KIID, to enable informed decision making on whether to invest in the UCITS. For example, the Central Bank identified cases where:
  - a. The disclosures in the Prospectus and KIID did not accurately describe the true nature of the UCITS's investment strategy e.g. active vs passive.
  - b. The information contained in the Prospectus and KIID was not consistent with the information contained in other fund documents such as the marketing material.
  - c. Marketing material explained the investment strategy more clearly than the Prospectus and KIID but the marketing material was typically only made available to institutional investors, potentially disadvantaging non-institutional investors.
  - d. UCITS did not disclose in the Prospectus or KIID that they are 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.
  
2. The Central Bank also found cases of poor governance and controls by Boards of UCITS Fund Management Companies (the "Board"), including:
  - a. Insufficient review and oversight of the offering documents.
  - b. Insufficient evidence of Board challenge regarding the chosen strategy of the UCITS.
  - c. Approving management fees in excess of the UCITS's targeted outperformance of the benchmark.
  - d. Insufficient oversight of the UCITS distribution and investment strategy.
  - e. 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 if the fees charged are commensurate with the level of actual active management and performance achieved.



3. The Central Bank found cases where multi-manager UCITS consistently delivered a performance similar to an index. This raised the question as to whether the diversification benefits of the multi-manager approach versus passive investing were being achieved by those UCITS over time. Where UCITS are using a multi-manager approach, the Board should consider whether this results in a strong correlation with an index to an extent that active management fees may not be appropriate.
4. 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 the UCITS. The result is 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.
5. The Central Bank found cases where the past performance section of the KIID did not include relevant benchmark disclosure. Therefore, investors in these UCITS are not able to determine from the KIID whether the UCITS, irrespective of performance, represented good value relative to its benchmark.

The Central Bank is concerned by the number of transparency issues identified during the Review. Boards are reminded of their responsibility for the disclosure and implementation of the investment policy for each managed UCITS, as set out in the Prospectus. Boards should actively consider the contents and findings in this letter as they carry out their role, and review and revise their Prospectus and KIID where necessary. When considering the accuracy of the content of its Prospectus and KIID the Board of each UCITS must ensure that:



- They are in compliance with all applicable legislative requirements and all relevant guidance. This includes Q&As issued by ESMA<sup>5</sup> and the findings of the Central Bank in this letter.
- Any marketing material or other documentation provided to investors is consistent with information contained in the Prospectus and KIID.<sup>6</sup>
- If the fund is managed in a constrained manner to a benchmark, this constraint is disclosed in the KIID and the Prospectus.
- Where the fund is being managed with a performance target, this is disclosed in the KIID and Prospectus in order to assist investors in making an informed decision.

Any necessary updates to the Prospectus and KIID should be submitted to the Central Bank by 31 March 2020.

Furthermore, when assessing the investment managers annual presentation<sup>7</sup>, the Board should consider if the UCITS has delivered on the stated objective and remains a viable and suitable investment for investors. This review should be documented and assess, inter alia, the UCITS performance, fee structure and investor base. The fees charged on all share classes within each UCITS should be reviewed to assess whether they are appropriate for the targeted level of outperformance of the UCITS against its benchmark.

This letter must be brought to the attention of all members of the Board and to the relevant responsible persons within the Fund Service Providers and to Designated Persons.

The Central Bank will have regard to the contents of this letter as part of future supervisory engagement.

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<sup>5</sup> [https://www.esma.europa.eu/sites/default/files/library/esma34-43-392\\_qa\\_ucits\\_directive.pdf](https://www.esma.europa.eu/sites/default/files/library/esma34-43-392_qa_ucits_directive.pdf)

<sup>6</sup> Prospective investors to be provided with all relevant information prior to investing.

<sup>7</sup> Part I(26) of the Fund Management Companies Guidance requires a comprehensive annual presentation from the investment manager to the Board



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Should you have any queries in relation to this letter, please contact:  
[themedinspections@centralbank.ie](mailto:themedinspections@centralbank.ie).

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Patricia Dunne'.

**Patricia Dunne**

**Head of Division**

**Securities and Markets Supervision**