



February 2016

## ESMA Statement on Potential Closet Index Tracking

### ■ Introduction

The European Securities and Markets Authority (“**ESMA**”) issued a statement earlier this month to inform stakeholders (including investors) about the potential for some European collective investment funds to be “closet index trackers” and to outline the work that ESMA has been doing in this area. This is unlikely to be surprising to many given the issue has been the subject of considerable attention (particularly by the media) throughout the European Union.

ESMA is focusing on what it says is the alleged practice in the European collective investment management industry where an investment fund, according to its prospectus, key investor information documents (“**KIIDs**”) and/or marketing documentation, claims to be managed in an “active” manner while in reality the investment fund remains very close to a benchmark requiring less input from the investment manager and is therefore more akin to a “passive” fund.

Taking into account the potential investor protection issues, ESMA has carried out analysis using a sample of funds and decided to focus on UCITS equity funds domiciled in the European Union that were not categorised as index-tracking funds. The sample was composed of more than 2,600 UCITS. The analysis carried out by ESMA and the results of the study have been enough for ESMA to conclude that additional supervisory work is needed.

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ESMA confirms that in many EU member states, competent authorities have launched or are in the process of launching specific investigations to determine the potential extent of closet indexing.

## ■ ESMA's Concerns

ESMA is concerned with the alleged practice from a number of investor related standpoints and can be viewed in the overall context of the effectiveness of investor disclosure and the expectations of investors from its asset managers. ESMA outlines the principal concerns as follows:

1. The existence of the practice could in ESMA's view mean that an investor may be making investment decisions based on an expectation that they will be provided with a more active fund management service than what they receive in practice while at the same time paying a management fee higher than that typically associated with a passive/less active management service.
2. Investors may be exposed to a different risk/return profile than they expect.
3. The fund documentation may not be providing investors with information that is clear, fair and not misleading. ESMA states that managers should expect supervisory consequences where evidence of incorrect disclosures is proven.

## ■ ESMA's Recommendations

ESMA sets out a number of recommendations to both management companies and investors.

*Management companies* – ESMA recommends that UCITS management companies carefully consider whether the information it provides to investors is an accurate interpretation of the performance objectives of the investment fund and the amount of risk taken to generate that return is in line with their obligations under the KIID requirements. This would include considering whether the requirements relating to the use of an index are applied effectively.

*Investors* – ESMA suggest that in order to make an informed investment decision an investor should make use of all the documentation available to them when selecting a product and to compare the key elements of the product to those of a number of other products (including some that adopt a different style of management).

## ■ Next Steps

ESMA confirms that it and national competent authorities have committed to additional work on potential closet indexing. This will include an active role for ESMA in the coordination of further

analysis carried out at the national level, while fuller investigations on a fund-by-fund basis will fall within the ambit of competent authorities as part of their regular supervisory work.

Further steps are likely in relation to ensuring market participants are complying with disclosure obligations to the full extent.

ESMA is considering whether there is a need for further clarification within this area (such as defining what is meant by active and passive management) with a view to creating a level playing field for all stakeholders across the European Union.

A copy of the full statement can be found here:

[https://www.esma.europa.eu/sites/default/files/library/2016-165\\_public\\_statement\\_-\\_supervisory\\_work\\_on\\_potential\\_closet\\_index\\_tracking.pdf](https://www.esma.europa.eu/sites/default/files/library/2016-165_public_statement_-_supervisory_work_on_potential_closet_index_tracking.pdf)

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