

STATEMENT

Supervisory work on potential closet index tracking

The European Securities and Markets Authority (ESMA) is issuing this statement to inform stakeholders and especially investors about the potential for some European collective investment funds to be ‘closet index trackers’, and to give details on the work that ESMA has been doing in this context.

Introduction

1. ESMA’s attention was drawn to an alleged practice in the European collective investment management industry 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 managed¹. This practice is commonly referred to as ‘closet indexing’ or ‘index hugging’.
2. In many EU Member States, NCAs have launched or are in the process of launching specific investigations, in addition to their regular monitoring and supervisory functions, to determine the potential extent of closet indexing in their jurisdictions, with a focus on equity funds at this stage. At the same time, the issue has been the subject of considerable attention by investor protection groups and the media throughout the European Union.

Reasons for issuing this statement

3. The issues around ‘closet indexing’ form part of a broader issue on the effectiveness of investor disclosure and the legitimate expectations of investors in respect of the service provided by some asset managers. Nonetheless, the potential practice of closet indexing in Europe raises questions that merit closer analysis. The analysis carried out by ESMA (see paragraphs 9 to 16 for more details) indicates that there might be a small, but not insignificant number of funds in the EU equity fund sector that may be closet index trackers. If the existence of this practice were to be confirmed by further supervisory scrutiny carried out at national level, this could mean that:
 - (i) investors could be making investment decisions based on an expectation that they will be provided with a more active fund management service than they receive in practice and, therefore, may be paying higher management fees than that usually envisaged for a passive/not significantly active management service;

¹ ESMA recognises that management fees may depend on a number of factors.

- (ii) investors may be exposed to a different risk/return profile than they expect; and
 - (iii) some asset managers may not provide clear descriptions of how funds are managed in key disclosure documents such as the fund's Prospectus and Key Investor Information Document (KIID).
4. ESMA considers it important that fund managers take their commitments in disclosure documents seriously. Managers should expect supervisory consequences where evidence for incorrect disclosures is proven.

ESMA's recommendations to management companies and investors

5. The current rules on fund disclosures require that fund managers provide investors with information that is fair, clear and not misleading. ESMA recommends that UCITS management companies carefully consider whether the information they provide to investors is an accurate interpretation of the performance objectives of the fund and the amount of risk taken to generate that return is in line with their obligations under the KIID Regulation.
6. During the qualitative analysis of investor documentation, it has come to ESMA's attention that where UCITS use benchmarks, there are different approaches to the extent to which they may deviate from that benchmark. Also, other metrics are disclosed but there is no consistency in their use.
7. The KIID Regulation requires that the description contained in the 'objectives and investment policy' section of the KIID shall cover those essential features of the UCITS about which an investor should be informed. This includes 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. Where a reference to a benchmark is implied, the degree of freedom available in relation to this benchmark shall be indicated, and where the UCITS has an index-tracking objective, this shall be stated. ESMA will assess whether there is a need for further guidance and clarification on the application of these requirements, and consider the merits of developing a general definition of active and passive management (and the distinction between the two²).
8. In order to put investors (both retail and professional) in a position to make an informed investment decision, ESMA suggests that they should make use of all the documentation available to them when selecting a product. When considering an investment in a UCITS equity fund, regardless of the style of fund management, investors may also wish to compare the key elements of the product to those of a number of other products (including some that adopt a different management style). Although past performance is not a reliable guide to future returns, there may also be value in assessing whether a fund has been able to achieve the objectives referred to in the fund documentation.

² For a definition of an actively-managed UCITS ETF as opposed to an index-tracking UCITS please refer to II.3. of the ESMA Guidelines on ETFs and other UCITS issues (2014/937).

These recommendations are equally relevant to investment advisers when selecting possible investments to be proposed to their clients.

ESMA's analysis of closet indexing

9. Taking into account the potential investor protection issues to which closet indexing could give rise, ESMA took the decision to look into this practice. The first step of the work, concluded at the level of ESMA, involved conducting research to determine whether any indication of closet indexing could be found at an EU-wide level.
10. ESMA constituted a sample of funds for the purpose of the study.³ In particular, ESMA decided to focus on UCITS equity funds, domiciled in EU Member States, that were not categorised as index-tracking UCITS and that had:

- assets under management of more than € 50mn;
- an inception date before 1 January 2005; and
- management fees of more than 0.65% of the net asset value (NAV) of the fund.

The above figures were selected to focus the study on UCITS with a significant size, a proven track record, and a management fee in the typical range of funds with an active management style. The resulting sample was composed of more than 2,600 UCITS. Out of these 2,600 funds, it was possible for ESMA to retrieve data for further analysis for 1,251 UCITS (sub-sample) for the period 2012-2014.

11. Quantitative results (see the table under paragraph 16 below) are presented at an EU-wide level and for three different sets of criteria to identify potential closet indexing funds. This approach took account of the difficulties in coming up with a suitable identification criterion that could serve as a common basis for analysis of different fund markets and their characteristics among EU Member States as well as small sample sizes for a number of Member States.
12. The quantitative analysis provided initial indicators of potential closet indexing funds. It was therefore complemented by qualitative research into the documentation of the identified funds, which aimed at checking whether the potential closet indexers identified by the quantitative analysis were describing themselves as active managers in their prospectuses and KIIDs. In their disclosures the vast majority of the identified funds described their management approach as active. Funds which clearly specified that they were fully or partly tracking an index or funds that disclosed limited discretion in regard to their benchmark were removed from the sample. The outcome of the qualitative analysis tended to confirm the results of the quantitative analysis.
13. The metrics used in the methodology were “*active share*”, “*tracking error*” and “ R^2 ” (r-squared). While the *active share* shows the percentage of the portfolio of a UCITS that does not coincide with the underlying equity benchmark, the *tracking error* shows the volatility of the difference between the return of the UCITS and the return of its benchmark. Seen in conjunction, and in relation to a given equity index, low active share and low tracking error indicate that the portfolio of a fund is close to that of the respective

³ The study was carried out by using the Morningstar commercial database.

index, which could be a sign for passive fund management. The R^2 ratio represents the percentage of a fund performance that can be explained by a change of performance in a benchmark index. The higher the R^2 , the closer the performance of the fund is correlated to that of the benchmark.

14. Notwithstanding the below results, ESMA is mindful of the limitations of the quantitative analysis. ESMA is aware that this part of the analysis represents a statistical model and that the results can only be a first step in the investigation of closet indexing. Definitive evidence, potentially leading to supervisory action, will require a more detailed follow-up by national competent authorities, including on the actual information provided by funds to investors.
15. To take into account local specificities of financial markets in the Member States, ESMA analysed three different sets of metrics, aimed at providing a range for the extent of potential closet index funds:
 - a. Funds with an active share of less than 60% and a tracking error of less than 4% were classified as potentially being closet indexers. This approach is based on academic research⁴ and is used by consumer organisations such as Finance Watch.
 - b. Funds with an active share of less than 50% and a tracking error of less than 3% were classified as potentially being closet indexers. This set of metrics could be more indicative in Member States with relatively small equity markets.
 - c. Funds with an active share of less than 50%, a tracking error of less than 3% and a R^2 of more than 0.95 (95%) were classified as potentially being closet indexers. In addition to active share and tracking error, R^2 was used as a third criterion to further sharpen the analytical focus.

Criteria	Potential equity closet indexing funds	Potential actively managed funds (equity)
Active share <60% + tracking error <4%	15%	85%
Active share <50% + tracking error <3%	7%	93%
Active share <50% + tracking error <3% + $R^2 >0.95$	5%	95%

16. The results of the study underline the need for additional supervisory work in this area.

⁴ See for example *Cremers, M./Petajisto, A.*: “How Active is your Fund Manager? A New Measure That Predicts Performance.”, *Review of Financial Studies*, 2007 and *Cremers, M./Ferreira, M./Matos, P./Starks, L.*: “*The Mutual Fund Industry Worldwide: Explicit and Closet Indexing, Fees, and Performance*” with respect to closet indexing specifically. On the topic of active vs passive management more generally, the following articles are of relevance: *Angelidis, T./ Giamouridis, D./ Tessaromatis, N.*: *Revisiting mutual fund performance evaluation*; *Dyck, A./Lins, K.V./ Pomorski, L.*: *Does Active Management Pay? New International Evidence*; and *Fama, E.F./French, K.R.*: *Luck versus Skill in the Cross-Section of Mutual Fund Returns*.

Next steps

17. ESMA 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 necessarily fall in the remit of national competent authorities, as part of their regular supervisory work. Together with national competent authorities, ESMA will also assess the need for further steps to ensure that all market participants comply with disclosure obligations to the full extent. Where ESMA has identified potential shortcomings in the UCITS framework that could create a potential for closet indexing (e.g. on disclosure obligations), it will analyse the need for further clarification, with a view to creating a level playing field for all stakeholders across the European Union.