

Central Bank of Ireland's Thematic Review on Closet Indexing: A Shot Across the Bows for UCITS Boards?

Authored by Dechert's Financial Services Group

August 2019

Dechert
LLP



Central Bank of Ireland's Thematic Review on Closet Indexing: A Shot Across the Bows for UCITS Boards?

August 2019 / Authored by Dechert's Financial Services Group

The Central Bank of Ireland (the "**Central Bank**") on 18 July 2019 published a '*Dear Chair*' letter to the industry (the "**Industry Letter**") highlighting the key supervisory issues identified in a thematic review of Irish domiciled UCITS investment funds ("**UCITS**") on the subject of closet indexing (the "**Review**"), and setting out certain actions to be taken to mitigate any concerns.

While no findings of closet indexing were made, the Industry Letter cites instances of poor governance and control by boards where investors were not given sufficient or accurate information in the prospectus or key investor information documents ("**KIIDs**") and a number of other transparency issues and sets out actions that boards should take to address these concerns.

Background to Closet Indexing and the Review

The European Securities and Markets Authority ("**ESMA**") has described closet indexing (also known as index hugging or closet index tracking) 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, in reality, the investments and performance of the fund tracks closely to a benchmark.

Such an investment strategy therefore requires less input from the investment manager, yet management fees are charged in line with those of funds that are considered to be actively managed.

In February 2016, ESMA published a statement providing details of its work on closet index tracking funds. This highlighted its concern that investors are not receiving the service or risk/return profile they expect based on a fund's offering documents while also paying higher fees compared to those typically charged for passive management. ESMA also announced that it would work with national regulators to determine whether further analysis and subsequent action would be necessary in this area to best protect investors.

In November 2018, Derville Rowland – Director General, Financial Conduct at the Central Bank, speaking at the Irish Funds London Symposium, referred to closet indexing and said, "*It is a key priority for the Central Bank to ensure that investors are not disadvantaged by funds operating in a manner that is not consistent with their disclosure,*" and that analysis of over 2,000 UCITS described as actively managed was already underway.

In early 2019, the Central Bank identified 182 UCITS for further consideration and completed specific follow up engagements with an initial group of 62.

In March 2019, ESMA updated its questions and answers on the application of UCITS Directive, (the "**ESMA UCITS Q&A**") clarifying the benchmark disclosure obligations for UCITS.

In July 2019, the Central Bank issued a '*Dear Chair*' letter (i.e. the Industry Letter) summarising the outcome of the Review.

The ESMA Effect

The Industry Letter is heavily influenced by the March 2019 update to the [ESMA UCITS Q&A](#) which clarified its requirements for benchmark disclosure by UCITS.

The ESMA UCITS Q&A clarify the UCITS KIID benchmark and past performance obligations in the following manner:

Benchmark disclosure

1. UCITS should clearly indicate, in the KIID, whether their strategy is ‘active’ (or ‘actively managed’) or ‘passive’ (or ‘passively managed’);
2. A UCITS managed in reference to a benchmark is one where the benchmark plays a role in the management of the UCITS, for example, in the explicit or implicit definition of its portfolio composition and/or performance objectives and measures (this clarification led to repeal of an existing Q&A on past performance); and
3. Investors should be provided with an indication of how actively managed the UCITS is, compared to its reference benchmark index.

Past performance

1. Where funds name a target in their investment objectives and policies, the performance should be disclosed against the target, even if the comparator is not named a ‘benchmark’; and
2. The performance disclosed in the KIID regarding a benchmark index should be consistent with performance disclosure in other investor communications.

The ESMA UCITS Q&A significantly expands the scope of how a UCITS might be considered to be managed with reference to an index by setting out a list of 9 examples of “*where an approach may include or imply a reference to a benchmark index,*” as set out in the table below.

Portfolio Composition	
1.	The UCITS uses a benchmark index as a universe from which to select securities. This applies even if only a minority of securities listed in the index are held in the portfolio and the weightings of the UCITS’ portfolio holdings diverge from their equivalent weighting in the index.
2.	The UCITS portfolio holdings are based upon the holdings of the benchmark index. For example: <ul style="list-style-type: none"> • The individual holdings of the UCITS’ portfolio do not deviate materially from those of the benchmark index. • Monitoring systems are in place to limit the extent to which portfolio holdings and/or weightings diverge from the composition of the benchmark index.
3.	The UCITS invests in units of other UCITS or AIFs in order to achieve similar performance to a benchmark index.
Performance Measures	
4.	Performance fees are calculated based on performance against a reference benchmark index.

5.	The UCITS has an internal or external target to outperform a benchmark index.
6.	Contracts between the management company and third parties, such as the Investment Management Agreement covering delegation of investment management, or between the management company and its directors and employees, state that the portfolio manager must seek to outperform a benchmark index.
7.	The individual portfolio manager(s) receive(s) an element of performance-related remuneration based on the fund's performance relative to a benchmark index.
8.	The UCITS is constrained by internal or external risk indicators that refer to a benchmark index (e.g. tracking error limit, relative VaR for global exposure calculation).
9.	Marketing issued by the UCITS management company to one or more investors or potential investors shows the performance of the fund compared with a benchmark index.

Many UCITS managers would regard the inclusion of a comparator benchmark in marketing materials and investor updates (as set out at 9 above) as being an essential requirement for the purposes of enabling investors to measure performance.

However, in so doing, these managers would not have typically considered themselves as managing the UCITS with reference to a benchmark accordingly to the normal indicators as set out at 1 to 8 above. Rather, they would have been concerned that to include a comparator index in the prospectus or KIID may give the mistaken impression that the UCITS is not actively managed.

This view was echoed in consultation responses to the Asset Management Market Study undertaken by the Financial Conduct Authority ("FCA") in June 2017 (the "FCA Market Study")¹

The FCA Market Study broke benchmarks into 3 categories – 'constraint,' 'target' and 'comparator,' the last of which meaning "an index or similar factor against which a fund manager invites investors to compare a fund's performance."

While respondents to the FCA Market Study were concerned that the *proposed "rules will have the unintended consequence of forcing funds to disclose a benchmark, even if it is not relevant to the way a fund is run,"* this did not alter the FCA's findings that benchmarks, including comparator benchmarks, must be referenced consistently across all Fund Documents.

The Industry Letter refers to a UCITS being "*managed in a **constrained** manner*" or "*with a performance **target***." While it does not specifically reference a comparator index, it does expect that where a comparator index in reference in the marketing materials, it should also be referenced in the Fund Documents for consistency.

Applicability of the Benchmarks Regulation

The ESMA UCITS Q&A states that "*a UCITS managed in reference to a benchmark index is one where the benchmark index plays a role in the management of the UCITS, for example, in the explicit or implicit definition of the portfolio's composition and/or the UCITS' performance objectives and measures.*"

¹ [FCA Asset Management Market Study Final Report](#) (MS15/2.3, June 2017).

Given this exhaustive definition, consideration will need to be given to whether Regulation (EU) 2016/1011 (the “**Benchmarks Regulation**”) will apply in all cases where a UCITS is managed in reference to an index.

The Benchmarks Regulation define the use of a benchmark in the context of an investment fund as “*measuring the performance of an investment fund through an index ... for the purpose of tracking the return of such index, of defining the asset allocation of a portfolio, or of computing the performance fees.*”

However, the ESMA questions and answers on the Benchmarks Regulation (last updated on 11 July 2019) (the [BMR Q&A](#)) clearly state that comparator benchmark indices are not subject to the Benchmarks Regulation, at A5.6:

“ESMA considers that indices referenced in the documentation of an investment fund solely to compare the performance of the investment fund should not be included in the scope of this definition, where no investment constraint on the asset allocation of the portfolio is established in relation to the index. This is without prejudice to other European or national rules governing the mentioning of indices in fund documentation.”

The Review

The 15,500 share classes of all 2,550 Irish authorised actively managed UCITS were individually analysed against over 2,500 indices using the analytical parameters of ‘*Tracking Error Volatility*’ (TEV), ‘*R²*,’ and ‘*Beta*.’ Of these, the Central Bank identified 182 UCITS for further review and commenced its engagement with 62 of these while indicating that it will continue its engagement with the remaining 120 UCITS over the coming months.

In addition to seeking to ascertain instances of closet indexing, the Review served as a test of the implementation of the Central Bank’s Fund Management Companies – Guidance (“**CP86**”), particularly with regard to ‘*Delegate Oversight*’ and ‘*Operational Issues*’ (dealing with record retention, archiving and retrievability, together with the maintenance of designated and monitored email addresses).

In its engagement with UCITS, the Central Bank noted, in its press release, that its concerns around closet indexing form part of a broader issue on the effectiveness of investor disclosure and the legitimate expectations of investors.

Delegate Oversight

As part of its engagement with the 62 UCITS, the Central Bank asked for detailed information including:

- report(s) or presentation(s) from the investment manager to the board of the UCITS prior to the issue of the prospectus and the launch of the UCITS to inform it of the investment approach the investment manager proposes to take;
- the most recent comprehensive annual presentation and quarterly reports from the investment manager to the board dealing with the UCITS;
- the decision procedure for buying/selling of assets for the UCITS;
- the most recent institutional pitch book/presentation and marketing materials;

- extracts from board minutes demonstrating consideration of proposed investment strategies and active decisions made on the UCITS; and
- investment committee reports (where applicable).

All of these requirements reflect the requirements imposed on boards regarding oversight on investment managers under CP86 and are taken directly from the CP86 playbook.

Operational Issues

UCITS were contacted via their designated email address and rigid turnaround times were set for the production of information to test the UCITS ability to meet the Central Bank's expectations with regard to document retention, archiving and retrievability under Part V of CP86.

In that regard, it is worth noting that the Central Bank expects documentation relating to the launch of a UCITS to be retained indefinitely.

Supervisory Engagement and Risk Mitigation Programmes

No specific findings of closet indexing were made. This contrasts with the outcome of similar reviews in the United Kingdom where there were specific findings that certain funds were *closet trackers*,² and in Norway where two large financial institutions were found not to have provided sufficiently active management of funds.³

Of the 62 UCITS in the original engagement, 57 were found not to have given *investors "sufficient or accurate information about the UCITS' investment strategy in the Prospectus or the [KIID]."* The Central Bank has since commenced '*supervisory engagement*' with these UCITS and requested that they undertake a '*Risk Mitigation Programme*' which involves updating their prospectus and KIIDs (collectively the "**Fund Documents**") and sending revised documentation to all investors, "*together with the Central Bank's findings which prompted the amendments.*"

These findings were typically that the UCITS met the threshold used by the Central Bank to identify potential closet indexing funds (the "**Central Bank Closet Indexing Threshold**"), namely:

- Tracking Error <3.5%
- Beta 0.9 – 1.1
- R² >0.9

Key Findings in the Industry Letter

The Industry Letter highlights key findings of the following cases from the Review:

1. *Insufficient, inaccurate and/or inconsistent disclosures about investment strategy.*

The Central Bank has suggested that investors were not always given sufficient or accurate information about a UCITS investment strategy in the Fund Documents to enable them to make

² Financial Conduct Authority. (2019). '[Closet trackers](#).'

³ Kjørven, M. (2019). '[Closet Index Funds and Retail Investor Protection – A Scandinavian Perspective](#).' Tilburg Law Review.

informed decisions on whether to invest in a UCITS, and that there were issues of consistency in disclosures.

Examples cited included inconsistencies between the Fund Documents and marketing materials (especially the inclusion of more detailed disclosure in marketing material not available to all investors) and the non-disclosure of risk limits linked to a benchmark index.

2. Poor governance and controls by boards.

The Central Bank identified instances of what it considers to be poor governance and control which included insufficient review and oversight of the offering documents, together with insufficient evidence of board challenge regarding the chosen strategy of the UCITS.

The CP86 framework mandates a detailed approval process prior to the launch of a UCITS, which also suggests that boards seek to review marketing materials to ensure that they do not significantly elaborate or conflict with the contents of the prospectus.

Further, the Central Bank commented that they had found instances of insufficient oversight of distribution and investment strategy, and a lack of regular assessment as to whether the performance of a UCITS was reflective of the active management investors were paying for, and if the fees charged were commensurate with the level of active management and performance achieved.

3. Multi-manager UCITS consistently delivering performance similar to an index.

Multi-manager UCITS were asked to consider the utility of the multi-manager strategy where there is a strong correlation to an index “to an extent that active management fees are not appropriate.”

4. UCITS have a target outperformance against a benchmark that is less than the fee charges to certain share classes in the UCITS.

The Central Bank found cases where boards had approved management fees in excess of the UCITS targeted outperformance of the benchmark.

The Central Bank commented that 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.

In the FCA Market Study, the FCA noted that active funds for sale in the UK, on average, outperformed benchmarks before charges were deducted, but underperformed benchmarks after deduction of charges by around 60 basis points.

5. Past performance section of the KIID did not include relevant benchmark disclosure.

The result of this insufficient or non-disclosure is that investors are not able to determine from the KIID whether the UCITS, irrespective of performance, represented good value relative to its benchmark.

Transparency Issues Identified

Of particular concern to the Central Bank was the prevalence of transparency issues arising from the Review, particularly with regard to insufficient, inaccurate and/or inconsistent disclosures about investment strategy. The Central Bank has reminded UCITS boards that they have ultimate responsibility for the disclosure and implementation of the investment policy of their UCITS and they may need to consider enhancing their Fund Document disclosure.

Many UCITS in Ireland have US investment managers who will commonly run a similar if not parallel strategy for a UCITS domiciled in Ireland through a (pre-existing) mutual fund established under the Investment Company Act of 1940 [15 U.S.C. 80a], (the “**40 Act**”) (such funds are often referred to as a “**40 Act Fund**”). Quite often, there is divergence in disclosure between the UCITS and the 40 Act Fund arising from UCITS requirements and Central Bank comments. The inclusion of enhanced disclosure in Fund Documents will increase this divergence

Delegate Oversight: Viability and Suitability for Investors

The Industry Letter also significantly expands the Delegate Oversight requirements under CP86 and introduces a new concept of consideration of viability and suitability.

Background to CP86 Delegate Oversight Requirements

CP86 requires that a board receives, “*and be satisfied with comprehensive annual presentations from the investment manager detailing developments affecting the manager itself, the investment process and strategy, the investment team, progress and performance (including strategy for responding to any underperformance) and any proposed development of the investment approach.*”

As part of the CP86 consultation process, the Central Bank invited a “*number of experienced professionals to work together to provide it with advice regarding good practices for directors of fund management companies in the oversight of delegates.*”

This group provided guidance which ultimately provided the basis for the delegate oversight section of CP86.

Enhanced Delegate Oversight Requirements – Viability and Suitability

While the original CP86 guidance was subject to a detailed consultation process, the Industry Letter has been issued without consultation and significantly expands the scope of delegate oversight by asking boards to: “*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 the UCITS should be reviewed to assess whether they are appropriate for the targeted level of performance of the UCITS against its benchmark.*”

The approach being taken by the Central Bank mirrors work that is being done by ESMA and other regulators such as the FCA.

Approaches to Performance

With regard to performance, the FCA Market Study noted that the worst performing funds were likely to be merged or closed and that “*while this self-correction mechanism [closure/merger] exists, it does not cover all poorly performing funds and can take a long time to happen.*”

In general, the FCA found that allied to self-correction, improving transparency with regard to objectives, use of benchmarks, costs and charges should “*equip investors to understand instances of persistent underperformance*” and, presumably, to act upon this data by redeeming, if it wished to.

Approaches to Fees

The Central Bank have been flagging for some time that the level of fees being charged by UCITS were a matter of regulatory interest. In a speech delivered on 11 June 2019, Michael Hodson – Director of Asset Management and Investment Banking at the Central Bank commented that the

Central Bank continue to “*view transparency and fees in the investment fund sector as a supervisory priority.*”⁴

The FCA Market Study also considered the role of boards with regard to fees and found that boards “*do not appear to exert effective challenge on value for money*” and that managers “*do not generally robustly consider value for money for fund investors.*”

To address this, the FCA has proposed changes to governance structures similar CP86 and the Irish Funds Corporate Governance Code for Collective Investment Schemes and Management Companies.

In April 2018, the FCA introduced new rules to ensure fund managers act as agents of investors in their funds and, in February 2019, introduced further complementary rules and guidance to improve the improve the quality of the information available to customers about the funds they invest in.

Approaches to Viability

United States

In the US, under the 40 Act, section 15(c) requires all 40 Act Fund’s directors to request and evaluate, and an investment adviser to a fund to furnish, such information as may reasonably be necessary to evaluate the terms of any advisory contract. As part of their fiduciary duties, boards of directors are required to evaluate the material factors applicable to a decision to approve an investment advisory contract which under the ‘*Gartenberg principles*’ include nature, extent and quality of service; performance; costs; adviser profitability and economies of scale.

United Kingdom

The FCA have adopted a similar approach [under the Market Study] with a requirement that all funds undertake an annual ‘*assessment of value*’ with an accompanying Gartenberg like table of minimum considerations.

These approaches may provide some assistance to UCITS boards on considering viability.

Applicability to Alternative / Private Funds

Whilst specifically undertaken with respect to UCITS, much of the procedures involved with the Review was in fact derived from CP86 requirements and may therefore be directly applicable to alternative investment funds (“**AIFs**”).

The boards of such funds, in particular retail investor AIFs, should be mindful of the findings and recommendations arising out of the review, and should consider taking appropriate steps to ensure compliance with the requirements of CP86 and the Industry Letter, bearing in mind that investor protection is one of the key priorities for any financial services regulator.

Next Steps for Fund Boards and Managers

1. Closet-Indexing

Review UCITS data against Central Bank Closet Indexing Threshold

⁴ Hodson, M. (2019). ‘[Fit for the future – Brexit, Supervision and Corporate Governance.](#)’ Central Bank of Ireland.

Given the very high number of UCITS that have had a negative finding made against them as part of the Review and the fact that 120 more may be subject to a review, it would be a useful risk mitigant for all UCITS to carry out analysis against the Central Bank Closet Indexing Threshold to establish if the UCITS might “*appear to be closely moving in line with an index*” in preparation for an inspection.

2. Transparency

Review and revise Fund Documents for accuracy of content to take account of the Industry Letter and the ESMA UCITS Q&A.

The ESMA UCITS Q&A require necessary changes to be made “*as soon as practicable or by the next KIID update following the publication of this Q&A*” whereas the Central Bank is indicated that necessary changes should be submitted by 31 March 2020.

3. CP86 Compliance

Review all UCITS launched before CP86 implementation through a CP86 “prism”

The Central Bank expects that all UCITS should be subject to the detailed scrutiny set out in CP86 irrespective of whether the UCITS was launched before implementation of CP86, particularly with regard to investment approach.⁵

Keep record-keeping policies under continuous review

The requirements of CP86 with regard to document retention and retrievability are demanding and the associated policies and procedures should be kept under continuous review to ensure compliance.

4. Viability and Suitability

Enhance the investment manager’s annual presentation

In addition to the matters referenced in CP86, the Industry Letter now requires an additional documented review of viability and suitability. Boards will need to consider how this requirement can be met.

The Industry Letter

The Industry Letter can be accessed on the Central Bank website [here](#).

⁵ Part I (A. Investment Management) (para. 24) of [CP86](#).

This update was authored by*:



Declan O'Sullivan
Partner, Dublin
+353 1 436 8510
declan.osullivan@dechert.com



Jeff Mackey
Partner, Dublin
+353 1 436 8521
jeff.mackey@dechert.com



Richard Frase
Partner, London
+44 20 7184 7692
richard.frase@dechert.com



Karen L. Anderberg
Partner, London
+44 20 7184 7313
karen.anderberg@dechert.com



Megan C. Johnson
Partner, Washington, D.C
+1 202 261 3351
megan.johnson@dechert.com



Colman O'Loghlin
Associate, New York
+1 212 698 3695
colman.ologhlin@dechert.com

*The authors would like to thank Paul Sweeney for his contribution to this update.

© 2019 Dechert LLP. All rights reserved. This publication should not be considered as legal opinions on specific facts or as a substitute for legal counsel. It is provided by Dechert LLP as a general informational service and may be considered attorney advertising in some jurisdictions. Prior results do not guarantee a similar outcome. We can be reached at the following postal addresses: in the US: 1095 Avenue of the Americas, New York, NY 10036-6797 (+1 212 698 3500); in Hong Kong: 27/F Henley Building, 5 Queen's Road Central, Hong Kong (+852 3518 4700); and in the UK: 160 Queen Victoria Street, London EC4V 4QQ (+44 20 7184 7000). Dechert internationally is a combination of separate limited liability partnerships and other entities registered in different jurisdictions. Dechert has more than 900 qualified lawyers and 700 staff members in its offices in Belgium, China, France, Germany, Georgia, Hong Kong, Ireland, Kazakhstan, Luxembourg, Russia, Singapore, the United Arab Emirates, the UK and the US. Further details of these partnerships and entities can be found at dechert.com on our Legal Notices page.