Regulator Review of Closet Trackers

Background

Closet tracking, closet indexing or index hugging refers to the practice of fund managers claiming to actively manage investment portfolios when in reality the fund closely tracks a benchmark. This leads to "active fees" being charged while the returns do not exceed those offered by an index. Higher fees for active funds may be justified by the higher level of management required to generate higher returns, while passive funds should charge less as the manager simply tracks stock market returns and trades less.

Closet tracking has been a key focus for the European Securities and Markets Authority ("ESMA") in recent years. In 2016, an analysis of 2,600 funds conducted by ESMA revealed that between 5% and 15% of UCITS equity funds could potentially be closet trackers.

The consumer group Better Finance found that around a third of European active equity funds do not include benchmark information in their Key Investor Information Documents ("KIIDs"), as is required for UCITS funds. This may result in the true level of index tracking not being fully transparent. The issue of closet tracking forms part of broader concerns at ESMA around the effectiveness of investor disclosure.

ESMA has resolved to put an end to this practice by seeking to ensure that national regulators carry out supervisory work on the ground. In June 2018, ESMA held a workshop to provide guidance to national regulators on closet tracking. It also intends to publish guidance or a Q&A clarifying the UCITS disclosure requirements.

To date, only the Financial Conduct Authority ("FCA") has taken action against closet tracking funds. Earlier in 2018, it said that work had resulted in managers paying out £34m to investors who were overcharged for closet trackers.

In October 2018, the French regulator *Autorité des Marchés Financiers* ("AMF") announced it was planning a new study to identify closet trackers.

Central Bank of Ireland ("CBI") Review of Closet Trackers

Derville Rowland, the CBI's director general for financial conduct announced in December 2018 that the CBI was investigating UCITS funds to ensure they were not misleading customers about charges and other issues in relation to closet tracking. A full desk-based review of the funds documentation such as KIIDs and prospectuses and the relevant disclosures therein will be assessed. The CBI intends to probe in excess of 2,000 UCITS funds that report to be actively managed.

The burden of proof will be on active fund managers to show the variance between their fund and the benchmark.

KB Associates' Services

KB Associates offers a range of services to investment funds and management companies including:

- The provision of UCITS/AIF management company services.
- The provision of designated persons to perform UCITS business plan and AIFMD programme of activity managerial functions.

If you would like to discuss any issues raised in this article or related to KB Associates' services in general, please feel free to contact Mike Kirby (+353 1 667 1980), Peter Northcott (+44 203 170 8813) or Mike Parton (+1 345 946 4224).

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