

PRESS RELEASE

European Regulator is flexing its muscles to tackle “Closet Indexing”

Brussels, 11 September 2020 - On 10 October 2014, [BETTER FINANCE](#) wrote to ESMA¹ to ask for an investigation into the issue of falsely “active” funds, a practice also known as “closet indexing”. Today, it praises ESMA for its considerable efforts towards addressing the issue.

Indeed, on 9 September, ESMA published a [Working Paper](#) on “Closet Indexing Indicators and Investor Outcomes”, confirming findings from research also carried out by BETTER FINANCE and pointing out that:

- Potential closet indexers obtain significantly lower returns (gross and net) than active managers, potentially making them the worst performers on the market;
- Although closet indexing costs less than active management, it is far more expensive than passive management (index tracking): “closet indexing funds face an unjustifiably high level of costs, far in excess of those for explicitly passive funds”.

Most importantly, ESMA now qualifies the practice of Closet Indexing as misconduct by asset managers, and, over the years, developed a “toolkit” that will allow it to engage in enforcement actions to address closet indexing:

- 1) In 2016, for its first report (that BETTER FINANCE replicated²), ESMA established metrics to identify potential closet indexers and distinguish them from genuinely active managers, but did not disclose the former.
- 2) In 2019 ESMA updated and clarified the legal basis for benchmark disclosure, necessary for the qualitative assessment of closet indexers. (In its [2018 Benchmark Disclosure Compliance Report](#), BETTER FINANCE regrettably also discovered widespread breaches of EU disclosure rules for investors, and found that, out of the 165 suspicious equity funds, 67 also failed to disclose their benchmark performance alongside the past performance of the fund, thus preventing investors from knowing how funds had performed against their objectives and whether these funds were indeed “hugging” their benchmark or not.)

In this working paper (2020), ESMA clarified the actual detriment suffered by investors and added an additional metric to be able to eliminate “false positive” closet indexers in its quantitative assessment.

Guillaume Prache, Managing Director of BETTER FINANCE, applauds these efforts by ESMA and believes that these supervisory developments will be key in addressing the detriment suffered by investors at the hand of Closet Indexers. He does however stress that *“it is clearer than ever that what investors need is for national supervisory authorities to finally follow-up on these investigations and sanction the closet indexers, as only the Norwegian and British ones have done so far. Therefore, ESMA should disclose, at least to the national supervisors, all funds that have been identified as potential closet indexers and mandate investigations into these, as there may be hundreds of thousands of EU retail investors affected by closet indexing on long-term horizons (10 years at least), which could amount to hundreds of EUR millions of losses for them.”*

Contact: Chief Communications Officer | Arnaud Houdmont | +32 (0)2 514 37 77 | houdmont@betterfinance.eu

¹ <https://betterfinance.eu/publication/letter-to-steven-maijoor-on-the-subject-of-closet-indexers/>

² Unlike ESMA, BETTER FINANCE disclosed the names of the 165 UCITS equity funds that were “potentially” falsely active.