BF BETTER FINANCE
The European Federation of Investors and Financial Services Users
Fédération Européenne des Épargnants et Usagers des Services Financiers

11 February 2016

To: Martin Merlin, Director of Financial Markets, DG FISMA, European Commission
Sven Gentner, Head of Unit, Asset Management, DG FISMA, European Commission

c.c. Lord Jonathan Hill, Commissioner for Financial Stability, Financial Services and Capital Markets Union
Olivier Guersent, Director General of DG Financial Stability, Financial Services and Capital Markets Union

Re: **The urgent protection of EU investors against falsely active funds ("closet indexing"): disclosure of the offending funds identified by ESMA**

Sirs,

I am writing to you on behalf of Better Finance, the European Federation of Investors and Financial Services Users, which represents the European individual investors and savers.

In 2014, the Danish financial supervisor revealed it had found that almost a third of Danish equity funds were in effect expensive clones of the indices, or « closet indexers »: mutual funds that claim to be actively managed, but that in reality charge high "active" fees for index-like performance, which would warrant much lower management fees. Typically low cost equity index funds such as index ETFs charge five to ten times lower fees than active ones. Therefore, the investor detriment is very important in that case.

On 10 October 2014, we wrote to the chair of ESMA (The European Securities &Markets Authority) to request an EU-wide investigation on closet indexing as we suspected this wrongdoing was certainly not limited to Denmark.

In September 2015, ESMA told us that they had completed a quantitative analysis on a sample of EU domiciled UCITS funds, using a similar methodology as the Nordic supervisors and as Better Finance Swedish member organisation Aktiespararna, but that it then needed to complete it with a "qualitative" analysis by researching the documentation provided by each fund.

On 2nd February 2016, ESMA released some results of its investigation[1] stating that the qualitative analysis confirmed the results of the quantitative one.

[1] ESMA found that up to 15 % of the UCITS funds it sampled are in all likelihood falsely active. 15% of the ESMA « sample » equals 390 UCITS funds; 15 % of the ESMA "sub-sample » equals 188 UCITS funds. ESMA did not disclose why it could work only on the « sub-sample ». However the sample is only composed of UCITS funds although German and French retail investors for instance are mostly sold "AIFs", not UCITS funds.

However ESMA - quite disappointingly after more than one year of investigations - refused to disclose the funds it identified as falsely active. It stated that - despite the research into the documentation of the funds it performed - "*definitive evidence will require a more detailed follow-up by national competent authorities*, *including on the actual information provided by funds to investors*". We however understand this was precisely what the ESMA "qualitative analysis" was about.

ESMA would even not communicate which national supervisors would be involved, if there is any timetable for those to finalise the public identification of closet indexers, or if/how ESMA will ensure those national supervisors will act promptly to eventually put an end to this investor detriment. Today EU investors are still left totally in the dark and the important detriment caused by closet index funds continues to prosper and grow in the EU[2].

In the meantime, the Norwegian supervisor has started and completed its own investigation, and has publicly sanctioned a closet indexing fund manager, thus acting effectively against closet indexing detriment caused to Norwegian investors.

We strongly believe the refusal from the EU supervisor to disclose the names of the offending funds it identified after more than a year of investigations is not compliant with its legal duty to enhance investor protection in the EU. One priority of the European Commission - through the "Capital Markets Union" initiative - is to restore investor confidence. This priority must be put into action. <u>Better Finance respectfully asks the European Commission to demand the full and immediate disclosure of the list of the funds identified as closet indexers by the ESMA investigation to EU investors</u>.

Sincerely,

Guillaume Prache
Managing Director

[2] ESMA only issued "recommendations " for investors (including retail ones) to use all the documentation available, and emphasized that there may be "*value in assessing whether a fund has been able to achieve the objectives referred to in the fund documentation*". However – at the same time – ESMA is finalising level II rules that eliminate all past performance disclosures in the Key Information Documents for funds. How will retail investors then be supposed to do that in the future?