

29th March 2017

Mr. Sven Gentner
Head of Unit C4 - Asset Management Unit
Dir C – Financial Markets
FISMA – Directorate General for Financial Stability,
Financial Services and Capital Market Union

Re: Closet indexing funds issues requiring action from the European Commission

Dear Mr. Gentner,

As you know, Better Finance replicated the ESMA quantitative study on equity closet indexing (ESMA PR and Statement of 02/02/2016), which are funds that claim to be actively managed (therefore charging high fees to clients) whereas in reality they try to imitate the funds benchmark (often underperforming it). The aim of this replication was making the results public in order to raise EU institution's attention and thus try to improve the situation of financial services users.

On 13 February 2017, Better Finance released the results of its investigation, making public the name and identification number of all the funds (including the most suspicious list), the name of the companies, the countries of domicile and other relevant information on the funds (such as Active Share (AS), Tracking Error (TE), and R-Square (R^2) when available).

We found out that just a minority of equity funds had been analysed. This is due to the fact that Alternative Investment Funds (AIFs) – although massively sold to retail investors in Europe (more than UCITS funds in many countries) - are not included from the study. Moreover, 57% of the UCITS funds are also excluded from the study because they do not disclose any benchmark (7% of them) or do not show relevant information (AS, TE, and/or R^2 , 50% of them). In the third party commercial fund data base that ESMA used as its only source (Morningstar).

Better Finance concluded that up to 7% of the funds analysed (16% of the funds with the relevant information available) are suspicious and could potentially be falsely active funds, based on ESMA metrics.

Furthermore, we also reviewed the investor disclosure documents, as ESMA did. But our review reveals a very serious compliance issue with EU Law: 41% of the funds which are potentially closet indexers according to ESMA metrics ("Classification 3" of ESMA: AS below 50%, TE below 3% and R^2 above 95%) do not disclose their benchmark's past performance alongside their own performance in their KIID. It is concerning that ESMA's review of disclosure documents did not identify this major problem, as the two-pages KIID was precisely designed to inform retail fund investors. This does not seem to comply with EU Law (Regulation 583/2010, articles 7.1(d) and 18) and makes it impossible for retail fund investors to assess the relative performance of these funds vis-à-vis their benchmark, as expressly recommended by ESMA.

Besides, this one and only ESMA recommendation to investors following its closet indexing investigation will be totally impossible to follow as relative past performance to benchmark will be

totally removed as a disclosure in the future Key Information Document (KID), the only fund disclosure document that retail investors are likely to read.

To foster retail investment into capital markets is a key objective of the EU CMU initiative. Restoring investor confidence in capital markets and in investment funds is a prerequisite. Besides, one of Actions of the CMU Action Plan aims at improving the transparency of the performance of long-term savings products. We ask the European Commission how it will ensure that retail fund investors be able to check if funds have really been active and if they have ever met their investment objectives, two basic information requirements that are not sufficiently enforced today, and will not even be required in the future, when the PRIIPs “KID” regulation kicks in.

Better Finance also asks the Commission to ensure that the above-mentioned articles 7.1(d) and 18 of EU Regulation 583/2010 be now enforced asap, and would appreciate to learn which practical actions it is going to take to do that, and how and when retail fund investors will be properly informed of them.

Lastly, Better Finance asks that ESMA urgently equips itself with a comprehensive and fully and easily accessible database of all EU domiciled funds (UCITS plus AIFs) so that it can actually fulfil its legal duties to “*monitor and assess market developments* » (article 8 (f) of the ESMA Regulation) and to collect, analyse and report on consumer trends (article 9.1 (a)), and so that EU investors can get reliable and trustworthy key information on investment funds.

We are keen to provide the EU institutions with information from our research project and support in any inquiries on this topic.

Yours Sincerely,



Guillaume Prache
Managing Director