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Central Bank publishes findings from closet-index review of UCITS funds

Background

As readers will be aware, significant work has been undertaken by regulators at both European and national level to eliminate the practice of closet-indexing by certain UCITS funds i.e. UCITS funds which indicate in their fund documentation that the fund is actively managed while in reality the fund is managed very closely to a benchmark (akin to a "passive" fund) but investors are charged active strategy fees.

At a European level, the work carried out by the European Securities and Markets Authority ("**ESMA**") on potential closet indexing culminated in the issue of a revised Q&A on UCITS (the "**ESMA UCITS Q&A**") in March of this year which obliges UCITS management companies to disclose in the KIID whether a UCITS is actively managed, actively managed in reference to a benchmark or passively managed.

At a national level, the Central Bank of Ireland (the "**Central Bank**") also announced late last year that it intended to conduct a review into closet indexing in Irish domiciled UCITS fund. It has now published the outcome of this review. In a letter issued to all Irish domiciled UCITS management companies and self-managed UCITS funds ("**Man Co**"), the Central Bank sets out the steps it expects these firms to take to mitigate against such practices.

Review of UCITS Prospectus and KIID

The Central Bank requires Man Co to review existing disclosures relating to the use of benchmark indices in their prospectus and

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KIIDs and make any necessary changes to these documents no later than **31 March 2020** to ensure investors are receiving sufficient and accurate information about the UCITS's investment strategy.

Man Co should now implement a review process to (i) ensure that the UCITS prospectus and KIID satisfy the requirements outlined below and, (ii) where they have not already done so, incorporate the additional disclosures into the KIID required under the ESMA UCITS Q&A, further information on which is available from our briefing earlier this year.

In particular, the Central Bank requires the following:

How the UCITS uses the relevant benchmark

While the ESMA UCITS Q&A already requires that the KIID discloses whether the UCITS is actively managed, actively managed in reference to a benchmark or passively managed, the Central Bank has called on all Man Co to ensure that the prospectus as well as the KIID provides investors with full information on the nature of the UCITS's investment strategy.

Where relevant, these documents should make clear whether the UCITS is being managed in a constrained manner to a benchmark. It should therefore be clear to investors whether a benchmark is being used solely for performance comparison purposes or whether it is being used as a performance target or its use could otherwise constrain the management of the portfolio.

Consistency across all fund documentation

Similar to the obligation imposed on Man Co under the ESMA UCITS Q&A, the Central Bank expects these firms to conduct a review to ensure that any marketing material or other documentation provided to investors is consistent with the information contained in the prospectus and KIID. In this regard, the Central Bank found in its review that in certain cases, the investment strategy was comprehensively disclosed to institutional investors in marketing presentations while non-institutional investors were not provided with the same level of information, thereby potentially disadvantaging them.

The board of directors of any externally managed UCITS fund should review and approve the revised prospectus and KIID prior to their issue.

Review of Governance and Control Framework

The Central Bank has also voiced its concern about the governance and control framework in place in certain Man Co.

Assessment of performance of the UCITS

Man Co must, as part of their assessment of the annual presentation of the Investment Manager required to be provided under the Fund Management Company Guidance (the "**Guidance**"), conduct a review of the performance of the UCITS, its fee structure and its investor base. The Man Co should use this information to determine whether each UCITS has delivered "*on its stated* *objective and remains a viable and suitable investment for investors*". The Central Bank is clearly setting out its expectations regarding the role of the Man Co in assessing the investment performance of the UCITS.

Approval and Oversight of UCITS funds

Among the other matters identified by the Central Bank were insufficient reviews of offering documents of the fund by the Man Co, a failure on part of the board of directors of the Man Co (the "**Board**") to have adequate oversight of the offering documents, UCITS distribution strategy and UCITS investment strategy and a failure to adequately challenge the chosen strategy of the UCITS,

While the Guidance already requires Man Co to consider some of these matters, governance arrangements currently in place within the Man Co for approving new funds should be reviewed to ensure that the Man Co can demonstrate to the Central Bank (through board minutes or other documentation) that the Board understands both the investment strategy and the distribution strategy for each fund and oversees the implementation of the investment strategy and distribution strategy during the life of the fund. The governance arrangements should also demonstrate that the Board reviews fund documentation prior to issue.

Review of management fees where the UCITS is managed with a performance target

In its findings, the Central Bank noted that there were certain UCITS which had a target outperformance against a benchmark which was less than the fee charged to certain share classes within the UCITS. In practice this means that investors could not realise a positive return against the benchmark even where the UCITS had performed positively against the benchmark because of the fact that the management fee cancelled out such outperformance.

Man Co must review the fee structure of any UCITS fund which has a target outperformance against a benchmark to ensure that the fee structure is such that shareholders will be able to realise a positive return against the benchmark where the UCITS has outperformed that benchmark.

Multi Manager UCITS funds

Man Co of multi-manager UCITS funds must consider whether this approach delivers a performance similar to an index. If this is the case, the Man Co should consider whether it is appropriate to charge active management fees. Any such assessment and, where relevant, the rationale for the fee structure, should be documented by the Man Co.

Should you have any queries in relation to this article, please contact the author or your usual contact in the Dillon Eustace Asset Management and Investment Funds Team for further information.

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