MFSA

MALTA FINANCIAL SERVICES AUTHORITY

11 July 2018

Attn: Compliance Officers, Risk Managers and Directors of: (i) UCITS Management Companies licensed in Malta; (ii) self-managed UCITS licensed in Malta; and (iii) Retail AIFs licensed in Malta which are either self-managed or third-party managed

Dear Sir/ Madam,

Re: Self-assessment in relation to the evaluation of potential closet indexing practices adopted by UCITS and Retail AIFs

1. Scope

This self-assessment applies to: (i) Self-managed Undertakings for Collective Investment in Transferable Securities ('UCITS') licensed in Malta; (ii) Management Companies managing UCITS licensed in Malta; (iii) Self-managed Retail Alternative Investment Funds ('Retail AIFs') licensed in Malta; (iv) Maltese AIFMs managing Retail AIFs licensed in Malta (collectively referred to as "ManCos").

N.B. UCITS and Retail AIFs are collectively referred to as 'Funds' for the purpose of this Circular.

Notwithstanding the first paragraph, any of the above-mentioned Funds which satisfies any of the following criteria:

- have NAV lower than EUR 10 000 000, or
- are charged Investment Management Fee lower than 0.8% of the Fund's NAV, or
- have already disclosed in the Offering Documentation the tracking of a benchmark, including but not limited to, volatility returns, geographical focus, i.e. approved index-tracking Funds

shall be excluded from the scope of this self-assessment.

2. The concept of Closet Indexing

Indexing, in general, refers to the practice of Fund Managers claiming to manage portfolios actively when in reality the Fund composition is close to a benchmark, whilst closet indexing

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related to indexing without appropriate disclosing of this activity to investors. This may give rise to a situation where investors are not receiving the service or risk/return profile they expect based on the Fund's Prospectus/ Offering Documentation while potentially paying higher fees compared to those typically charged for passive management.

As part of its supervisory work on ManCos, the MFSA is currently undertaking an exercise to determine the extent of potential closet indexing in Malta. In this regard, the MFSA requires ManCos to conduct a self-assessment on all Funds[1] managed by them, as further explained in Section 7 below and to report their findings to the Authority.

3. Applicable Regulatory Framework

In 2016, the European Securities and Markets Authority ('ESMA') issued a Public Statement [ESMA/2016/165] on potential closet index tracking. Moreover, Regulation (EU) No 583/2010 (KIID Regulation) requires that the description contained in the *'objectives and investment policy'* section of the KIID shall cover essential features of the Fund about which an investor should be informed, including whether the Fund allows for discretionary choices regarding particular investments, and whether this includes or refers to a specific benchmark. Where a reference to a benchmark is implied, the degree of freedom available in relation to this benchmark shall be indicated, and where the Fund has an index-tracking objective, this shall be clearly stated.

SLC 3.50 of Part BII of Investment Services Rules applicable to Investment Services Licence Holders qualifying as UCITS Management Companies clearly outlines the need of the ManCo to act honestly, fairly and professionally in accordance with the best interests of the Fund if when conducting their investment management activity. Moreover, SLC 6.2.12 of Part BII of Investment Services Rules for Rules for Retail Collective Investment Funds applicable to Malta based Retail UCITS Collective Investment Funds requires the KIID to be fair, clear and not misleading. ManCos are therefore required to abide by the investment objectives, policies and restrictions stipulated in the KIID and Offering Documentation.

Furthermore, in Part BIII of Investment Services Rules applicable to Investment Services Licence Holders qualifying as AIFMs, SLC 10.06 provide that all information, including marketing communications addressed by the AIFM to retail investors or potential retail investors is subject to the requirements of Article 11 of the Investment Services Act and shall be fair, clear and not misleading. Additionally, SLC 2.04 of the Investment Services Rules for Rules for Alternative Investment Funds requests the governing body of a Retail AIF to act honestly and in good faith in what they consider to be the best interests of the AIF's investors.

[1] In the case of Maltese AIFMs managing AIFs licenced in Malta, this exercise is to be restricted solely to Retail AIFs. Also please refer to the exclusions set out in Section 1.

4. Distinction between an actively-managed Funds and an Index-tracking Funds based on the UCITS Framework

Based on the definitions provided in Section II.3 of the Guidelines for competent authorities and UCITS management companies - Guidelines on ETFs and other UCITS issues, an actively-managed UCITS ETF is defined as: *a UCITS ETF, the manager of which has discretion over the composition of its portfolio, subject to the stated investment objectives and policies (as opposed to a UCITS ETF which tracks an index and does not have such discretion). An actively-managed UCITS ETF generally tries to outperform an index.*

Conversely, index-tracking UCITS is defined as: *a UCITS the strategy of which is to replicate or track the performances of an index or indices e.g. through synthetic or physical replication.* Consequently, an actively-managed UCITS involves greater degree of analysis, research, etc. as compared to management of an index-tracking UCITS. Understandably, the fee structure of both types of Funds differs, with higher management fees typically levied in the case of actively-managed ETFs as opposed to index-tracking ETF.

5. Closet indexing and its impact on investors

Closet indexing typically occurs when a ManCo claims that it is managing the assets of the Fund in an active manner, while in actual fact, the asset allocation of the Fund is close to replicating an index, whilst charging fees that are typically applicable for actively-managed Funds.

Closet indexing leads to situation where the Fund does not disclose that it is being managed by reference to a benchmark. Such a practice will eventually lead to a deviation from the Fund's investment policies, objectives and information documentation initially provided to investors. Closet indexing relates to a broader issue of importance of the appropriateness and quality of the information disclosure to investors, the legitimate expectations of investors in respect of the service provided by key functionaries of the Fund and ultimately, overall investor protection.

Without prejudice to the fact that management fees depend on a number of factors, closet indexing leads to a situation where investors would be paying management fees which is normally attributed to an active management service and when there is no clear disclosure in the Prospectus/ Offering Documentation that the management fee paid pertain to a Fund which is tracking an index.

6. The methodology for a self-assessment

ManCos, as defined above, are being requested to carry out an exercise to determine whether each of the Fund under their management is potentially a closet indexer or index hugger. As an initial step, the ManCos should identify an appropriate financial index that more or less represents a reasonable universe of the potential securities the actively managed Fund is allowed to invest in as described in its investment objective compared to a benchmark. In terms of SLC 4.14(ii) of Part BII of Investment Services Rules for Retail Collective Investment Schemes, a financial index shall fulfil the below:

(a) the index measures the performance of a representative group of underlyings in a relevant and appropriate way;
(b) the index is revised or rebalanced periodically to ensure that it continues to reflect the markets to which it refers following criteria which are publicly available; and
(c) the underlyings are sufficiently liquid which allows users to replicate the index.

For the sake of clarity, this benchmark should be the (standard) *point of reference* against which the performance of a given Investment can be measured. The chosen benchmark should reflect the strategy/ type of securities of the Fund as much as possible. An index tracks the performance of a broad asset class, such as all listed stocks, or a narrower portion of the market, such as technology company stocks, which are used as a benchmark for the Fund portfolio.

Among major indices are: S&P 500, Dow Jones Industrial Average, FTSE 100, FTSE 350, Eurostoxx 50 and market index stocks PowerShares QQQ ETF, Vanguard 500 Index, and SPDR S&P 500 ETF. The ManCos should exercise their judgement when selecting an index, which in their view is the most appropriate to the respective Fund in terms of investment strategy and portfolio composition. Any Benchmark applied to a Fund should be agreed in consultation with the Depository of the Fund. It is acknowledged that in certain cases, appropriate benchmarks may be hard to identify and in such instances, the assessment should be considered on a "best-efforts" basis.

7. Assessment of the Fund

ManCos should determine whether a Fund falls under the below criteria classifying it as a potential closet indexer by considering: (a) "*active share*", (b) "*tracking error*" and (c) "*R2*" (r-squared) as all-inclusive metrics, as a minimum.

The below metrics are often readily available and calculated automatically by leading providers of financial information such as Bloomberg, Thomson Reuters and MorningStar. In this regard, and in view that the major metrics are nowadays publicly available, the use of data from financial information service provides is recommended. In absence of reliance on these service providers, ManCos could use the following formulas to compute the relevant metrics.

(a) Active Share may be defined as:

$$Active\ share = \frac{1}{2}\sum_{i=1}^{N}\left|w_{fund,i} - w_{index,i}\right|$$

where $w_{fund,i}$ is the weight of stock i in the Fund's portfolio, $w_{index,i}$ is the weight of the same stock in the Fund's benchmark index, and the sum is computed over the universe of all assets. Active Share is thus the percentage of a Fund's portfolio that differs from a Fund's benchmark index. In other words, Active Share is the percentage of Fund holdings that is different from the benchmark holdings. A Fund that has no holdings in common with the benchmarked index will have an Active Share of 100%, and a Fund that has exactly the same holdings as the benchmarked index will have an Active Share of 0%.

(b) Tracking error volatility, often called tracking error is where:

$$Tracking\ error = Stdev\left[R_{fund} - R_{index}\right]$$

where the time-series standard deviation (*Stdev*[2]) of the difference between the Fund return R_{fund} and its benchmark index return R_{index} is computed.

The *tracking error* indicates the volatility of the difference between the return of the Fund and the return of its benchmark. Seen in conjunction, and in relation to a given equity index, low active share and low tracking error indicate that the portfolio of a Fund is close to that of the respective index. In other words, tracking error is the annualized standard deviation of daily return differences between the total return performance of the Fund and the total return performance of its underlying index.

(c) The R^2 ratio

The R^2 ratio (referred to as '*R2*' and '*R-Squared*') represents the percentage of a Fund performance that can be explained by the performance in a benchmark index. The higher the R^2, the closer the performance pattern of the Fund to that of the benchmark. It can be treated as a percentage, showing the proportion of a Fund's performance that can be attributed to that of the benchmark. Values upward of 0.7 suggest that the Fund's behaviour is increasingly linked to its benchmark.

For the sake of clarity, R-Squared is not a measure of correlation but it is the coefficient of determination.

[2] Standard deviation is a measure used to quantify the amount of variation or dispersion of a set of data values.

The R^2 ratio can be calculated as:

$$R^2 = \frac{\left(n \sum R_{xi} R_{yi} - \sum R_{xi} R_{yi}\right)^2}{\left[n \sum (R_{xi})^2 - \left(\sum R_{xi}\right)^2\right]\left[n \sum (R_{yi})^2 - \left(\sum R_{yi}\right)^2\right]}$$

where the ***n*** is number of observations, R_{xi} is the market excess return (i.e. market proxy return minus risk-free proxy return) and R_{yi} is the portfolio's excess return (i.e. portfolio return minus risk-free proxy return). R^2 value of 0.1 (100%) indicates Fund's performance fully reflecting that of the benchmark.

(d) Additional metrics (optional)

To complement the above-explained metrics, it is also recommended that ManCos take into consideration the following metrics:

(i) Beta

Beta is a coefficient measuring a relative volatility of an asset or a portfolio in comparison to the market as a whole. In other words, it measures a portfolio's sensitivity to overall market movements. In practice, Beta is measured by comparing changes in the price of an asset to changes in the value of an index over a given time period. If a Fund has beta equal to 1, it could potentially be tracking an index and in the case of beta -1 it could potentially be inverse tracking an index.

Beta is calculated as a covariance of the return of an asset with the return of the tracked index divided by the variance of the return of the benchmark over a certain period.

Beta is calculated as:

$$Beta = \boldsymbol{Corr}_{(i,m)} \times \left[\frac{\sigma_i}{\sigma_m}\right]$$

Beta coefficient can be interpreted as follows:

$\beta = 1$	exactly as volatile as the market
$\beta > 1$	more volatile than the market
$\beta < 1 > 0$	less volatile than the market
$\beta = 0$	uncorrelated to the market
$\beta < 0$	negatively correlated to the market

(ii) Sharpe Ratio

Share Ratio can be defined as the reward to variability, as it measures risk-adjusted performance that uses a benchmark based on the ex-post market line.

It is computed as a portfolio's risk premium divided by the standard deviation for the portfolio's return.

Sharpe ratio is calculated as:

$$Sharpe\ Ratio = \frac{(R_x - R_f)}{StDevR_f}$$

Where $\boldsymbol{R_x}$ is the expected portfolio return, $\boldsymbol{R_f}$ is the risk free rate of return and $\boldsymbol{StdDevR_x}$ is the standard deviation of portfolio return (or volatility). The higher the ratio, the greater the investment return relative to the amount of risk taken.

Sharpe Ratio can be interpreted as follows:

< 1	Bad
1 – 1.99	Adequate/good
2 – 2.99	Great
Greater than 3	Excellent

(iii) Number of holdings

Number of holdings of a Fund provide an indication of the management activity of a Fund. Whilst index trackers have a high number of holdings, the diversified, actively managed Funds would typically have a lower number of holdings (typically less than 50).

8. Interpretation of results

The following three all-inclusive scenarios indicate that a Fund is potentially a closet-indexer:

Scenario 1:	Funds with an active share of less than 60% and a tracking error of less than 4%
Scenario 2:	Funds with an active share of less than 50% and a tracking error of less than 3% (applicable to relatively small equity markets);
Scenario 3:	Funds with an active share of less than 50%, a tracking error of less than 3% and a R^2 of more than 0.95 (95%)

While the active share shows the percentage of the portfolio of a Fund that does not coincide with the underlying equity benchmark, the tracking error shows the volatility of the difference between the return of the Fund and the return of its benchmark. Seen in conjunction, and in relation to a given equity index, low active share and low tracking error indicate that the portfolio of a Fund is close to that of the respective index, which could be an indication of passive fund management. The R^2 ratio represents the percentage of a Fund performance that can be explained by a change of performance in a benchmark index. The higher the R^2, the closer the performance of the Fund is correlated to that of the benchmark, which is also a sign of possible passive management. The additional metrics, including Beta, Sharpe ratio and the number of holdings of a Fund, which may be used by ManCos for the purpose of self-assessment, could reinforce the outcome of the analysis conducted.

9. Limitations of the methodology

The Authority is mindful of the limitations of these models but it is of the view that these are representative parameters that should lead to further investigation by ManCos if the Funds under management fall within the applicable scenarios. The result of the self-assessment shall be seen as an *indication* that the Fund may potentially be a closet-indexer. In this regard and for the purpose of this exercise, ManCo shall exercise their judgement accordingly and assess whether any action are required to be taken as explained in Section 12 below.

10. Exceptional circumstances for allowance of index-tracking

Without prejudice to the generality of the requirements under this Circular, it should be noted that due to certain macroeconomic events affecting the industry at large, at ManCos of a Fund which should be actively managed shall be allowed to track an index in order to mitigate external risks. On such occasions, the ManCo shall provide rationale for tracking an index, at Authority's request.

The allowance or exceptional index-tracking by an actively-managed Funds must satisfy all of the following criteria:

(i) it must be caused by external and unforeseen circumstances of a macroeconomic nature; and

(ii) the period of such exceptional index-tracking shall typically not be longer than three (3) months;

(iii) the exceptional index-tracking situation must be duly reported in the Compliance Log of the Fund; and

(iv) ManCo shall inform the Authority and of occurrence of the exceptional index-tracking, within thirty (30) days of commencement of tracking of an index and report this matter in the annual report and audited financial statements covering this period.

Should there be a reason for extension of the period stated in point (ii) above, the ManCo shall consider converting the Fund into an explicitly authorised Index-tracker and shall liaise with the Authority accordingly.

11. Maltese UCITS managed by an EU Manager

Maltese UCITS managed by an EU Manager are to engage with the said Manager and agree on what actions need to be taken with a view to undertaking checks vis-à-vis potential closet indexing of the Fund. Actions taken are to be discussed at governing body level and recorded in its minutes.

12. Way forward

UCITS ManCos are requested to conduct a self-assessment involving all three (3) mandatory metrics explained in Section 7 above, as a minimum, and provide details to the MFSA of the findings of the exercise.

In the case that UCITS have been identified as potential closet-indexers a more detailed review is required and remedial actions should be considered, possibly including:

(a) conversion of the Fund into an index-tracker, subject to investors' consent and regulatory approval;
(b) more transparent disclosure on the fees charges borne by investors;
(c) disclaimers that the Fund may potentially be tracking an index;
(d) revision of fee structures,
(e) reimbursement of past fees, etc.

If a Fund is identified as a closet indexer, investors should as a minimum be allowed to redeem their holding, without any exit fee or penalty.

Conversely, in the case where the Fund assessed is not being a closet indexer, no material action is to be taken other than to report position to the MFSA on the outcome of the self-assessment by way of template attached. The MFSA may review the position in relation to ManCos managing closet indexing Funds, notably in cases which are not reported to us.

Either way, applicable workings for each Fund are to be retained at the registered address of the ManCos and submitted to the governing body of the Fund for their consideration. The Authority's may request to access such documentation during on-site compliance visit of either the Fund and/or ManCos.

ManCos are to provide the Authority with the attached certificate **by 28 September 2018.** The certificates shall be submitted strictly to: indextracking@mfsa.com.mt

Notwithstanding the Authority's request to conduct the self-assessment, and if applicable, provide the MFSA with relevant report by the above-stipulated deadline, the ManCos are being advised that they are expected to conduct such self-assessment on an on-going basis, and at least:

(a) Semi-annually for Funds which NAV is higher than EUR 100 000 000;
(b) Annually for Funds which NAV is between EUR 10 000 000 and EUR 100 000 000.

Contacts

Any queries or requests for clarifications regarding this Circular are to be addressed in writing to the Securities and Markets Supervision Unit, MFSA via e-mail on: indextracking@mfsa.com.mt.

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Potential closet indexing practices adopted by UCITS and Retail AIFs dated 9 July 2018

Self-assessment Certificate

NAME of self-managed Fund / ManCo: ______________________________

Malta Financial Services Authority
Securities and Market Supervision Unit
FAO: Funds Team
Notabile Road
Attard BKR 3000
Malta

Date ……………………………..

Dear Sir / Madam,

Re: Self-assessment in relation to the evaluation of potential closet indexing practices adopted by UCITS and Retail AIFs

We confirm that we have undertaken the self-assessment on potential closet indexing practices in line with the guidance provided by the MFSA and report as follows*:

□ **The conducted self-assessment does not indicate that any of the assessed UCITS is potential closet indexer**

OR

□ **The conducted self-assessment shows that the following Fund(s) are (potential) closet indexers and the following actions have been or are being considered to remedy the situation**

FUND: ……………………………………………………………………………………………………
………

ACTIONS: ………………………………………………………………………………………………
………
………

TIMELINE FOR IMPLEMENTATION OF THE ACTIONS:……………………………… ………………

We confirm that our workings have been documented and have been submitted to the governing body of the Fund(s).

Sincerely,

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Authorised Signatory(ies)

* *Tick as applicable*