

November 29, 2012

Via email to MARKT-BENCHMARKS-CONSULTATIONS@ec.europa.eu
European Commission
B-1049 Brussels
Belgium

Re: Consultation Document on the Regulation of Indices

Dear Sir or Madam:

The Investment Company Institute¹ (“ICI”) and ICI Global² appreciate the opportunity to comment on the European Commission (“Commission”) Consultation Document on the Regulation of Indices (the “Consultation”). ICI and ICI Global members collectively manage nearly \$15 trillion in regulated investment funds such as mutual funds, closed-end funds, and exchange-traded funds (“ETFs”).

The Consultation appears to focus on the use of benchmarks to price financial instruments such as interest rate swaps and forward rate agreements, as well as commercial and non-commercial contracts.³ It makes only a passing reference to their use for asset management purposes, such as to

¹ The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$13.8 trillion and serve over 90 million shareholders.

² ICI Global is the global association of regulated funds publicly offered to investors in leading jurisdictions worldwide. ICI Global seeks to advance the common interests and promote public understanding of global investment funds, their managers, and investors. Members of ICI Global manage total assets in excess of US \$1 trillion.

³ See, e.g., Consultation at 2, 7-8, 19. ICI and ICI Global members invest and trade a substantial amount in fixed income and derivative instruments that reference benchmarks such as LIBOR. Our views on the regulation and oversight of benchmarks used as a reference in financial instruments are discussed in a comment letter to the Wheatley Review on LIBOR. See letter from Paul Stevens, President and CEO, Investment Company Institute, and Dan Waters, Managing Director, ICI Global, to The Wheatley Review, dated September 7, 2012, available at <http://www.ici.org/pdf/26495.pdf>.

evaluate an asset manager's performance against a stock index, describing such uses as "other than as a benchmark."⁴

These asset management applications of indices are fundamentally different from the reliance on a benchmark to price financial instruments. Asset managers use indices for two primary purposes: as a method of evaluating an active manager's performance, *e.g.*, to demonstrate how well such a manager performs in selecting securities relative to a benchmark, and as a target for passive managers to track in managing an index fund.⁵ While not immune, indices that are used for either of these purposes are far less conducive to manipulation than benchmarks used to price financial contracts, for several reasons.

First and foremost, there is little opportunity for an asset manager – or anyone else that might have an interest – to manipulate such indices. Moreover, commercial providers of indices used by asset managers have every incentive to prevent such manipulation. The index business is extremely competitive; any loss of faith in the integrity of an index would cause serious commercial damage to the index provider. At the same time, the provider has little to gain by allowing an index to be manipulated. That is, while an entity that relies on a benchmark to establish a price paid or received for an instrument may benefit from a reduction (if paying) or an increase (if receiving) in the value of the benchmark, the business interests of commercial index providers, as well as those of the asset managers relying on the indices, are best served if the performance of an index accurately reflects the financial value it is intended to measure.

For these reasons, we urge the Commission to carefully distinguish the use of indices as a reference by asset managers from the use of indices to price financial instruments as it considers potential regulation. As explained in our letter to the Wheatley Review on LIBOR, we support consideration of ways to improve the governance and oversight of financial benchmarks,⁶ but any such regulation must be narrowly tailored to address the underlying concerns.

To assist the Commission in its review, we offer the following input regarding indices that are used as a reference by asset managers. Our comments follow the topics outlined in the Consultation.

⁴ Consultation at 8. *But see* Consultation at 21, referencing certain types of indices used as benchmarks for ETFs as potentially presenting concerns.

⁵ *See, e.g.*, 2012 ICI Factbook at 226, available at www.icifactbook.org (defining an index mutual fund as "[a] fund designed to track the performance of a market index"); ESMA Report and Consultation Paper, Guidelines on ETFs and other UCITS Issues (July 25, 2012) at 43, available at <http://www.esma.europa.eu/system/files/2012-474.pdf> (defining an "index-tracking UCITS" as "[a] UCITS the strategy of which is to replicate or track the performance of an index or indices...").

⁶ *See* letter from Paul Stevens, President and CEO, Investment Company Institute, and Dan Waters, Managing Director, ICI Global, *supra* note 3.

1. Indices & Benchmarks: What are They, Who Produces Them and for Which Purposes

Defining Indices and Benchmarks

The Consultation offers the following proposed definition of benchmark:

*Any commercial index or published figure calculated by the application of a formula to the value of one or more underlying assets or prices, including estimated prices, interest rates or other values, or surveys **by reference to which the amount payable under a financial instrument is determined.**⁷ [emphasis added]*

We note that the emphasized text in the proposed definition would appear to exclude the use of benchmarks or indices by asset managers, as such use does not determine the pricing of a financial instrument. If the Commission's intent is to exclude such use from the scope of its examination and any potential regulation, we urge that it explicitly state this exemption in its definition of benchmark. As discussed below, based on the concerns expressed in the Consultation, which are not implicated by asset managers' use of indices, we believe this result is appropriate. If, however, the Commission did not intend such an exclusion, its definition should more clearly capture the use of indices by asset managers, and any future regulations should recognize and distinguish these uses as appropriate.⁸

Who Produces Them

Asset managers typically use indices produced by commercial vendors. Many of these index producers are well-known: Standard & Poors, Dow Jones, MSCI, FTSE, and Russell, to name a few. Asset managers typically purchase data on the index constituents from these providers. Managers of index funds additionally enter into license agreements to obtain the necessary rights to use the intellectual property associated with the index, such as the name and trademarks. Asset managers generally do not contribute to the formulation of these indices. Some index fund providers, however, create their own indices or use indices created by affiliated entities. As discussed below, fund regulators across the globe have recognized the potential conflicts of interest that could arise from this structure and have imposed requirements designed to address them.

For Which Purposes: Use and Selection of Benchmarks by Asset Managers

As noted above, asset managers use indices for two primary purposes: as a method of evaluating an active manager's performance, *e.g.*, to demonstrate how well such a manager performs in selecting securities relative to a benchmark; and as a target for passive managers to track in managing an index fund.

⁷ Consultation at 8.

⁸ The Commission's intent is not apparent from the Consultation. *See supra* note 4 and accompanying text.

Some actively managed funds have a stated investment objective of outperforming a selected benchmark; others may state their objective in more general terms (*e.g.*, “to achieve long-term capital appreciation”) but show their performance relative to a securities index in fund disclosures and/or marketing materials.⁹ In order to show such a comparison, funds must purchase data (*i.e.*, the precise composition and pricing of the index) from the index provider.

Index funds typically state that their primary objective is to track the returns of their stated benchmark. They pursue this objective either by holding all of the securities in the index in proportional amounts (“replicating” the index) or by holding a representative sample of the securities in the index (“sampling” the index); some index funds also use derivative instruments such as futures and swaps to achieve their investment exposure. In addition to the data necessary to pursue their strategy, index funds must also license the intellectual property associated with the index – that is, the right to use the name and other trademarks of the index.

Fund managers select their indices based on a wide range of factors and subject to careful diligence. Chief among these factors is the market the index measures and its formula for doing so. Fund managers also consider the reputation of the index provider and the costs of licensing the index and related data. Firms reach different conclusions about the relative merits of each of these factors, a fact that has been explored heavily in the media recently after a major index fund manager announced that it was changing indices for a number of funds.¹⁰

2. Calculation of Benchmarks: Governance and Transparency

The Consultation recognizes that, where discretion is applied in the production or calculation of the data underlying an index, “conflicts of interest will arise where someone exercising this discretion also has an interest in the value of the benchmark.”¹¹ We agree. Three elements of this statement, however, bear additional exploration: the level of discretion involved in the index production or calculation, the opportunity for any individual to manipulate those inputs, and the interest in doing so.

As a preliminary matter, there is a wide variety in the level of discretion involved in the production of financial benchmarks and indices. With respect to the production of indices used by asset managers, which typically track segments of the securities markets, in most cases the underlying

⁹ All funds regulated by the U.S. Securities and Exchange Commission (“SEC”) are required to show their performance relative to “an appropriate broad-based securities market index,” and may show additional indices as well. *See* SEC Form N-1A, Item 4(b)(2)(iii).

¹⁰ *See, e.g.*, Olly Ludwig and Cinthia Murphy, “Vanguard to Drop MSCI Index on VWO,” *IndexUniverse*, Oct. 2, 2012, available at <http://www.indexuniverse.com/sections/features/14699-vanguard-to-drop-msci-index-on-vwo.html>.

¹¹ Consultation at 10.

data is taken from a regulated exchange or other source of market bids, offers, or executed prices.¹² This is in stark contrast to benchmarks such as LIBOR, which require subjective estimates of the price of theoretical transactions.¹³ Additionally, commercial vendors that license their indices to asset managers publish a great deal of information about their methodology and selection criteria – far more information than is available about the methodology of LIBOR – and index fund managers carefully monitor the index formulation and constituents to ensure that the criteria are being followed.

More importantly, even with respect to aspects of an index’s composition that are more subjective, such as the categorization of countries (*e.g.*, which countries should be considered “frontier,” “emerging,” or “developed” markets) or appropriate capitalization ranges (*e.g.*, how to distinguish large cap, mid cap and small cap securities), there is little opportunity for manipulation. These decisions are in the sole discretion of the commercial index provider, pursuant to the published methodology. Asset managers and others may be invited to participate on advisory committees organized by the index providers to share market insight, but such committees are advisory in nature and have broad participation, such that attempts at manipulation would be neither effective nor unnoticed. Further, as discussed in Part 4, commercial index providers themselves have a far greater interest in maintaining the integrity of their indices than in any potential manipulation.

As to index providers that are affiliated with funds that track their indices, fund regulators have carefully considered the potential conflicts of interest that may arise, and have taken steps to address them. For example, for “self-indexed” ETFs regulated under the Investment Company Act, the SEC has imposed a number of conditions relating to transparency and separation of tasks, which are specifically designed to prevent manipulation of the index to benefit (or harm) the fund.¹⁴ These conditions leave little opportunity for a fund manager to manipulate the index. Moreover, as the SEC has indicated, these conditions are arguably unnecessary in light of provisions in the federal securities

¹² Indeed, some regulatory regimes impose specific criteria on indices in order to be eligible for use by regulated investment funds. For example, the UCITS Directive imposes requirements with respect to an index’s diversification, adequacy as a benchmark for the market to which it refers, and transparency. Similarly, the Code of Unit Trusts and Mutual Funds, published by the Hong Kong Securities and Futures Commission, requires indices to, among other things, have clearly defined objectives and be objectively calculated and rules-based.

¹³ In our letter to the Wheatley Review, we expressed support for the concept of using available transaction data on bank borrowings to corroborate LIBOR, and recommended further exploration of whether LIBOR rates should be maintained for maturities and currencies for which insufficient transaction data is available. See letter from Paul Stevens, President and CEO, Investment Company Institute, and Dan Waters, Managing Director, ICI Global, *supra* note 3, at 3-4.

¹⁴ These include requiring the index provider to (i) make publicly available all of the rules governing inclusion and weighting of securities in each index; (ii) limit the ability to change such rules and provide public notice before any changes are made; (iii) impose “firewalls” between the staff responsible for index design and the portfolio management staff; (iv) maintain an unaffiliated “calculation agent” who is responsible for all index maintenance, calculation, dissemination, and reconstitution activities; and (v) specify a limited periodic basis on which the components of the index may be changed. See, *e.g.*, Wisdom Tree Investments, Investment Company Act Release Nos. 27324 (May 18, 2006) (notice) and 27391 (June 12, 2006) (order).

laws and exchange rules that protect against conflicts of interest and misuse of non-public information.¹⁵ Similarly, as ESMA recently noted, specific provisions in the UCITS Directive address conflicts of interest when an index provider is affiliated with an index fund's manager, including transparency requirements, published policies and procedures, and independent valuation.¹⁶

Finally, it is worth considering the potential benefits to any involved party of manipulating a securities index against which an asset manager is evaluated. Unlike benchmarks on which financial contracts are based, these indices do not dictate payments from one party to another, so there is no opportunity for direct gain. The performance of an index fund – and by extension the fund's manager – is primarily measured by how well it tracks the target index,¹⁷ rather than the direction the fund moves; thus, an index fund manager has little incentive to seek to manipulate the index. In theory, an active manager might wish to suppress an index to make its performance appear stronger, but doing so would require an opportunity that, as noted above, is not likely to present itself. Finally, as discussed below, commercial index providers have very strong incentives to maintain the integrity of their indices.

3. The Purpose and Use of Benchmarks

The Consultation states that ideally “a benchmark should be the best possible measure of the economic reality its users face.”¹⁸ It explains that contracts referenced to a particular index generally are not perfectly aligned with the economic interests the index represents, and queries whether steps should be taken to restrict the use of benchmarks to avoid such misalignment. While we agree with the ideal, we recognize that it is not feasible to have a benchmark for every possible economic reality, and we believe market participants are capable of making the necessary adjustments to account for the imperfect fit of a benchmark. Thus, we would not support a regulatory approach to restricting the use of benchmarks. We do, however, strongly support imposing a fiduciary standard – which is even

¹⁵ Indeed, in a 2008 ETF rule proposal, the SEC proposed eliminating the conditions on the basis that these laws and regulations are sufficient. *See* Exchange-Traded Funds, Proposed Rule, SEC Release Nos. 33-8901 and IC-28193 (March 11, 2008), 73 Fed. Reg. 14618 (March 18, 2008), *available at* <http://www.sec.gov/rules/proposed/2008/33-8901.pdf>. The proposal has not been adopted.

¹⁶ *See* ESMA Report and Consultation Paper, Guidelines on ETFs and other UCITS Issues, *supra* note 5, at 16-17 (further stating that no further consideration of these conflicts of interest by ESMA is necessary).

¹⁷ Indeed, index funds that sample their index typically state that a principal risk of the fund is a divergence of the fund's performance from that the index. Some index fund disclosures further explain that because the fund seeks to track an index, the fund will not seek temporary defensive positions when markets decline or seem overvalued. *See, e.g.*, iShares Russell 1000 Growth Index Fund Prospectus, *available at* http://us.ishares.com/content/stream.jsp?url=/content/en_us/repository/resource/prospectus/is_p_iwfp.pdf&mimeType=application/pdf, at S-2.

¹⁸ Consultation at 19.

stronger than the “suitability” standard referenced in the consultation – on those who offer personalized investment advice to retail investors.¹⁹

That said, it is not clear that the Commission’s concerns about inappropriate use of benchmarks apply to the use of indices by asset managers. In view of the wide variety of index²⁰ and actively managed²¹ funds available, as well as the disclosure such funds and their underlying indices provide, investors and their advisers should be able to choose an investment fund that matches their investment objective. Moreover, as noted above, an asset manager’s use of an index is always public and subject to an agreement with the index provider, so unauthorized use of an index should not occur.

4. Provision of Benchmarks by Private or Public Bodies

The Consultation notes the public interest in ensuring the integrity of certain benchmarks, and questions the extent to which public institutions should play a role in the provision of benchmarks. It observes that banks and investment firms produce indices to be used by ETFs, and other independent providers also produce indices for a profit, and states that “conflicts of interest and commercial incentives may mean that these ... commercial entities are less motivated to question submissions or impose stringent audit trails and otherwise ensure the integrity of their index.”²²

With respect to indices that are used by asset managers, we respectfully disagree. As discussed above, asset managers do not participate in the submission process or otherwise have opportunity to manipulate the indices on which they rely. Perhaps more importantly, independent index providers have a strong commercial incentive to provide high quality indices for asset managers. In connection with the recent announcement that a major index fund manager was changing indices for a number of its funds, the losing index provider announced that it would lose \$24 million in revenue, or 6 percent of its forecast earnings for 2013, and its stock price fell by over 26 percent.²³

¹⁹ See, e.g., Statement of Paul Schott Stevens, President and CEO of the Investment Company Institute, Hearing on “Ensuring Appropriate Regulatory Oversight of Broker-Dealers and Legislative Proposals to Improve Investment Adviser Oversight,” Subcommittee on Capital Markets and Government Sponsored Enterprises, Committee on Financial Services, United States House of Representatives, September 13, 2011, at 2-3, available at http://www.ici.org/pdf/11_house_fiduciary_stndrd_tmny.pdf.

²⁰ There are nearly 2000 index funds available in the U.S. (1092 ETFs and 871 mutual funds). *Source*: ICI data as of September 30, 2012.

²¹ There are over 6000 actively managed funds available in the U.S. (6198 mutual funds and 42 ETFs). *Source*: ICI data as of September 30, 2012.

²² Consultation at 21.

²³ See Chris Flood, “Index providers face rockier road,” *Financial Times*, October 9, 2012, available at <http://www.ft.com/intl/cms/s/0/ccc67a14-0e38-11e2-b87e-00144feabdc0.html#axzz2Cgz700O7>.

Asset managers may change indices for a variety of reasons. While the fund manager in the recent case was motivated by cost, other managers have changed indices to create better opportunities²⁴ or improve the risk profile of a fund.²⁵ Presumably a commercial index provider that allowed – or was even perceived to allow – manipulation of its products would stand to lose far more than it could gain from any potential manipulation. Indeed, index providers themselves recognize the importance of maintaining their brand and reputation. As a CEO of a major index provider recently explained, “[t]he brand associated with an index is important. It gives the investor knowledge of the process, of the role of the index provider – we are not a product issuer – and it takes away the issue of conflict of interest.”²⁶

5. Impact of Potential Regulation: Transition, Continuity and International Issues

The Consultation acknowledges the global nature of indices and benchmarks. We agree that even indices based on a market or sector specific to a single country may be developed and/or used by an entity outside that country. This is particularly the case for indices used by managers of index funds. Many major index providers based in the U.S. offer indices on a wide range of markets and sectors globally; non-US index providers also provide indices based on US markets. Thus, to avoid inconsistent regulation across similar products, as well as the possibility of “jurisdiction shopping,” any approach to regulation of indices should be undertaken globally. To that end, we note that the International Organization of Securities Commissions (“IOSCO”) recently formed a Board Level Task Force on Financial Market Benchmarks to consider many of the same issues described in the Consultation.²⁷ We urge the Commission to engage with that initiative as it continues its consideration of these important issues.

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²⁴ See, e.g., Invesco Powershares Water ETFs Index Change FAQ, available at <http://www.invescopowershares.com/pdf/P-FAQ-FLY-4-E.pdf> (explaining that the change was made to “position its business for future growth opportunities and to align its family of ETFs with the changing investment landscape”).

²⁵ See, e.g., “State Street Global Advisors Announces New Benchmarks for Five SPDR ETFs,” Press Release, October 24, 2011, available at <https://www.spdrs.com/resources/news/article.seam?newsId=1893134650> (explaining that the new indices would “offer broader diversification and reduced concentration risk”).

²⁶ Paul Amery, “What’s An Index Worth?” *Index Universe*, October 17, 2012, available at <http://www.indexuniverse.com/sections/features/14840-whats-an-index-worth.html> (quoting Alex Matturri, CEO of S&P Dow Jones Indices).

²⁷ “IOSCO Creates Board Level Task Force on Financial Market Benchmarks,” IOSCO Media Release, September 24, 2012, available at <http://www.iosco.org/news/pdf/IOSCONEWS250.pdf>.

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We sincerely thank you for this opportunity to share our views. If we or our members can be of further assistance as you consider this important matter, please do not hesitate to contact the undersigned.

Sincerely,

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