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Re: Consultation on Principles for Benchmarks-Setting Processes in the EU

Dear Mr. Maijoor and Mr. Enria,

ICI Global[1] appreciates the opportunity to comment on the joint European Securities and Markets Authority (ESMA) and European Banking Authority (EBA) consultation on principles for benchmark-setting processes in the European Union (EU) (referred to hereafter as the "Consultation").[2] ICI Global members manage over €750 billion in publicly available regulated investment funds. Many of these funds invest and trade in financial contracts referenced to benchmarks such as LIBOR and EURIBOR, and some also manage funds that are designed to track the performance of indices more generally. Therefore, ICI Global members have a strong interest in the recommendations on benchmarks setting processes put forward by EBA-ESMA Task Force (referred to hereafter as "the Task Force").

For the reasons explained below, we strongly believe that one size *does not* fit all when it comes to the regulation of benchmarks, and that the Task Force can and should draw distinctions between survey-based benchmarks, such as LIBOR, and other types of benchmarks, such as commercial indices licensed by regulated funds.[3] The Consultation identifies a number of serious concerns with respect to survey-based benchmarks, and the Task Force is to be commended for seeking to address them. To the extent the Task Force wishes to expand its review to other categories of benchmarks that have not exhibited the same types of failures (*e.g.,* commercial indices), it should begin by identifying specific, tangible concerns that warrant regulatory intervention. Only then should it seek to develop regulatory recommendations, and such regulations should be specifically designed to address those concerns.

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[1] 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.

[2] Consultation Paper – Principles for Benchmarks-Setting Processes in the EU, 11 January 2013 (available from http://www.esma.europa.eu/system/files/2013-12.pdf)

[3] In this letter, we use the term "survey-based benchmark" to refer to benchmarks, such as LIBOR, that are determined based on surveys or other subjective submissions. We use the term "commercial index" to refer to commercially provided indices that are licensed for a fee, such as the S&P 500 or FTSE 100. Unlike survey-based benchmarks, the data for commercial indexes is typically taken from a regulated exchange or other source of market bids, offers, or executed prices, and is not based on voluntary submissions.

As the Task Force has acknowledged, a number of other reviews into financial benchmarks are being undertaken by various policymaking bodies. These include reviews at international level by IOSCO[4], at regional level by the European Commission[5], and in various jurisdictions including notably the Wheatley Review in the UK.[6] We have submitted our specific comments in response to each of these reviews in turn but, as a general comment, we would strongly urge the Task Force to ensure that its policy responses are as coordinated and consistent as possible with those of these other reviews.

Our comments on the Consultation are set out below. All of our comments are consistent with those we have provided in response to the consultation published by IOSCO and we note that the Task Force considers that the Principles it develops will be aligned to those of IOSCO.[7] In general, we focus on the Consultation as it could be interpreted to relate to commercial indices used to measure the performance of a security, and specifically, a security issued by a regulated "index" or "tracker" fund.[8] As will be clear from our comments below, there is a significant body of existing regulatory requirements and guidelines in the EU that govern the investment in or the replication of indices by these funds.

Definitions and Scope

The Consultation clearly has roots in recent events that have eroded confidence in the credibility of LIBOR and similar survey-based benchmarks. As is the case with IOSCO's consultation and the definition of "benchmarks" proposed by the European Commission in the recent EU market abuse legislative reforms, the scope of this Consultation is however far broader. Specifically, the definition of what constitutes a benchmark refers to the concept of measuring or assessing the performance of a financial instrument. IOSCO contemplates that its recommendations would apply not only to benchmarks such as LIBOR, but also to exchange-traded products that track indices, such as ETFs.[9] The references in the Consultation to the activities of individual and collective portfolio management activities[10] would appear to capture an even broader range of products in the EU.

The very first question in the Consultation is whether we agree with this scope. As suggested above, we see it as overly broad. Commercial indices do not share the characteristics that underlie the erosion of confidence in LIBOR, namely, a survey-based methodology that is susceptible to manipulation. As a result, any attempt to develop of a single set of regulatory principles to address the entire diverse universe of benchmarks and commercial indices would be ill advised, in our view.

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[4] Consultation Report on Financial Benchmarks, IOSCO, January 2013 (available from http://www.iosco.org/library/pubdocs/pdf/IOSCOPD399.pdf). Comment Letter from Karrie McMillan, General Counsel – ICI and Dan Waters, Managing Director – ICI Global to Mr Alp Eroglu, IOSCO, dated 11 February 2013 (available from http://www.ici.org/pdf/27001.pdf)

[5] Consultation Document on the Regulation of Indices, European Commission, 5 September 2012 (available from http://ec.europa.eu/internal_market/consultations/docs/2012/benchmarks/consultation-document_en.pdf). Comment letter from Paul Stevens, President and CEO, Investment Company Institute, and Dan Waters, Managing Director, ICI Global, to the European Commission, dated 29 November 2012 (available from http://www.ici.org/pdf/26738.pdf)

[6] The Wheatley Review of LIBOR: Initial Discussion Paper, August 2012, available from http://hm-treasury.gov.uk/d/condoc_wheatley_review.pdf. Comment Letter from Paul Stevens, President and CEO, Investment Company Institute, and Dan Waters, Managing Director, ICI Global, to The Wheatley Review, dated 7 September 2012, available from http://www.ici.org/pdf/26495.pdf (the "ICI/ICI Global Wheatley Review Letter").

[7] Paragraph 8 of the Consultation

[8] We use the term "regulated fund" to refer to funds and ETFs that are registered in the United States under the Investment Company Act of 1940, in Europe pursuant to the Undertakings for Collective Investment in Transferrable Securities ("UCITS"), or elsewhere in the world under similar regulatory regimes. Funds that are designed to closely track the performance of a benchmark are commonly referred to as "index" or "tracker" funds.

[9] *See* Consultation at pages 9 (for Exhibit 1) and 48 (for the definition of "benchmark").

[10] Paragraph 11(x) of the Consultation

ICI and ICI Global have supported efforts to reform the process for establishing LIBOR and other survey-based benchmarks.[11] In particular, we support measures that could strengthen the credibility of those benchmarks, make the rate-setting process more fact-based and transparent by using transaction data to the greatest extent possible, and improve governance over rate submissions and calculations.

Commercial indices, on the other hand, are subject to existing regulation and market forces that provide a number checks and balances that mitigate the concerns expressed over LIBOR and other survey-based benchmarks. We therefore urge the Task Force to evaluate benchmarks and commercial indices separately. Should the Task Force identify any concerns specific to commercial indices, it should then examine whether regulatory or market-based solutions already exist to address those concerns. Only if the Task Force finds that its concerns are not adequately addressed should it consider regulatory recommendations.

For example, the UCITS Directive sets out criteria for investment funds whose policy is to replicate the composition of a certain stock or debt securities index which in turn has to be recognised by regulatory authorities.[12] Furthermore, the Eligible Assets Directive (EAD) lays down a number of additional criteria concerning the diversification, adequacy and publication of financial indices into which UCITS may invest or replicate.[13] This is in turn supplemented by CESR guidelines governing the eligibility of financial indices as investments for UCITS including where they are comprised of specific underlying assets such as financial derivatives on commodities and property[14] and based on hedge funds.[15]

As we have outlined in further detail below, we consider that the Task Force should take account of the existing framework of regulation in determining whether it is necessary to impose additional layers of regulation through the interim Principles it is proposing.

Benchmarks-setting processes

The Consultation sets out the Task Force's concerns and outlines a number of general considerations on benchmarks. While the Consultation lists the range of different types of benchmarks to illustrate the breadth of different asset classes, the Task Force should furthermore draw an initial distinction among benchmarks based upon the documented failures in the governance and controls around survey-based benchmarks. To the extent the Task Force wishes to expand its review to other categories of benchmarks that have not exhibited the same types of failures (*e.g.,* commercial indices), it should begin by identifying specific, tangible concerns that warrant regulatory intervention. Only then should it seek to develop regulatory recommendations, and such regulations should be specifically designed to address those concerns.

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[11] See the ICI/ICI Global Wheatley Review Letter.

[12] Article 53 of DIRECTIVE 2009/65/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (referred to hereafter as the "UCITS Directive"), available from http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:en:PDF

[13] Article 9 of COMMISSION DIRECTIVE 2007/16/EC of 19 March 2007 implementing Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards the clarification of certain definitions (referred to hereafter as the "Eligible Assets Directive"), available from http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2007:079:0011:0019:EN:PDF

[14] CESR Guidelines Concerning Eligible Assets for Investment by UCITS, March 2007 (available from http://www.esma.europa.eu/system/files/07_044.pdf)

[15] CESR Guidelines Concerning Eligible Assets for Investment by UCITS - The classification of hedge fund indices as Financial Indices, July 2007 (available from http://www.esma.europa.eu/system/files/07_434.pdf)

Principles of good conduct for benchmark setting

The remainder of the Consultation proposes a number of Principles concerning the general framework for benchmark setting and those firms involved in the submission of benchmark data and the administration, calculation, publication and use of benchmarks.

Question 2 of the Consultation asks whether a set of Principles is a useful interim measure until a possible formal regulatory and supervisory framework has been established in the EU. In response, we would challenge the extent to which additional regulation in any form, including a set of interim Principles, is necessary to ensure the utility or credibility of commercial indices. We do not believe that ESMA has identified concerns with respect to commercial indices, nor considered any factors that may mitigate those concerns. Such factors may include existing regulations or market forces. For example, as set out above, UCITS are already subject to a considerable framework of regulation in connection with their investment in and replication of commercial indices. Moreover, licensees are sophisticated investors that will only pay for a high quality product. Unless they are satisfied, the index will not gain traction in the marketplace.

Rather than comment on each of the Principles outlined in the general framework for benchmark setting proposed in Box A in the Consultation, we have set out below why we consider that these concerns, while valid with respect to survey-based benchmarks such as LIBOR, are simply not relevant to the production of commercial indices used by asset managers.

- *The data is more robust.* The underlying data for securities indices is typically taken from a regulated exchange or other source of market bids, offers, or executed prices. The Eligible Assets Directive explicitly requires that financial indices as referenced in the UCITS Directive rely on "sound procedures to collect prices" and furthermore include "pricing procedures for components where a market price is not available".[16] This is in stark contrast to survey-based benchmarks such as LIBOR, which require subjective estimates of the price of theoretical transactions.[17]

- *Administrators have less discretion.* There is far less administrator discretion with respect to a commercial securities index, and what minor discretion the administrator has presents little opportunity for manipulation.[18] The UCITS Directive explicitly requires that financial indices "represent an adequate benchmark for the market to which they refer".[19]

- *Interested parties have no meaningful opportunity to influence.* 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. Moreover, the asset managers are not submitters of the data underlying the indices.

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[16] Article 9(1)(c)(i) of the Eligible Assets Directive

[17] 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* the ICI/ICI Global Wheatley Review Letter, *supra* note 4, at 3-4.

[18] For example, administrators might have discretion with regard to the precise parameters for 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), but these decisions are made in accordance with the administrator's disclosed methodologies.

[19] Article 53(1)(b) of the UCITS Directive.

- *Administrators have every incentive to prevent manipulation.* Most importantly, index providers have a strong commercial incentive to provide high quality indices for asset managers. Any commercial index provider that allowed—or was even perceived to allow—manipulation of its benchmarks would stand to lose far more than it could gain from any potential manipulation.

These characteristics of commercial indices used by asset managers provide effective checks against the concerns detailed in the Consultation.

Principles for firms involved in benchmark data submissions

The Consultation sets out a number of concerns over potential conflicts of interest that may arise in the benchmark setting process and Principles B.2. – B.4. propose a number of measures concerning organisation and administration arrangements and conflicts of interest policies. We agree that conflicts may arise, but as we have also suggested to IOSCO we urge the Task Force to take care in distinguishing the nature and types of conflicts that may arise with survey-based benchmarks, such as LIBOR, from those that may arise in the context of commercial indices.

As discussed above, there is little opportunity or incentive for an asset manager—or anyone else that might have an interest—to manipulate commercial securities indices. As a preliminary matter, the underlying data for securities indices is typically taken from a regulated exchange or other source of market bids, offers, or executed prices, and any index reconstitutions follow a stated methodology and generally are announced in advance of their effective dates. These features leave little opportunity for manipulation. Additionally, unlike benchmarks on which financial contracts are based, these indices do not dictate payments from one party to another, so there would be no direct gain associated from any manipulation. The performance of an index fund—and by extension the fund's manager—is primarily measured by how well it tracks the target index,[20] rather than the direction the fund moves; thus, an index fund manager has little incentive to seek to manipulate the index.

Moreover, commercial index administrators have every incentive to prevent such manipulation. The index business is extremely competitive; any loss of faith in the integrity of an index would mean commercial ruin to the index provider. At the same time, there is little self-serving benefit to the provider in 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.

[20] 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_iwf.pdf&mimeType=application/pdf, at S-2.

Potential conflicts may be greater in the context of funds that track indices administered by an affiliate—a context that fund regulators have carefully considered and addressed. In the United States, for example, the SEC imposes a number of conditions relating to transparency and separation of tasks on "self-indexed" ETFs regulated under the Investment Company Act, which are specifically designed to prevent manipulation of the index to benefit (or harm) the fund.[21] These conditions leave little opportunity for a fund manager to manipulate the index. In addition, a framework of federal securities laws and exchange rules protect against conflicts of interest and misuse of non-public information.[22] 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.[23]

Ultimately, while the potential for conflicts of interest clearly is an appropriate area for securities regulators to evaluate, we do not believe that this Consultation identifies a sufficient basis for concern with respect to the potential for conflicts of interest in commercially provided securities indices.

Principles for benchmark administrators

Box C sets out a number of Principles for benchmark administrators. These require in general terms that administrators ensure the existence of robust methodologies for the calculation of the benchmarks, appropriately oversee the operation of this methodology and ensure an appropriate level of transparency to the market regarding the benchmark's rules. These are important questions but again we encourage the Task Force to focus not just on transparency but also on the appropriate role of regulation in achieving that transparency.

In this regard, we do not believe additional regulation is necessary to ensure sufficient transparency with respect to commercial securities indices. Administrators that license their indices to asset managers provide a great deal of information about their methodology and selection criteria—far more information than is available about the methodology of LIBOR—and asset managers carefully monitor the index formulation and constituents to ensure that the criteria are being followed. This information certainly allows the licensing asset manager to assess the credibility, representativeness, relevance, and suitability of a benchmark on an ongoing basis. Asset managers demand this information as part of their due diligence in selecting and monitoring their investment portfolios.

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[21] 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.,* WisdomTree Investments, Investment Company Act Release Nos. 27324 (May 18, 2006) (notice) and 27391 (June 12, 2006) (order).

[22] Indeed, the SEC has indicated that the self-indexed ETF conditions are arguably unnecessary in light of these provisions in the federal securities laws and exchange rules. 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, *supra* note 26. The proposal has not been adopted.

[23] *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).

The Consultation's suggestion that the benchmark administrator should fully disclose the methodology[24], including as appropriate to the market[25], is unnecessary and, moreover, would have significant negative consequences. First, requiring benchmark administrators to publicly disclose methodologies in such detail that any user—not just a licensee—could replicate their index harms fund investors by facilitating "free riding" (in which investors outside an index fund can replicate the strategy, while investors in the fund pay for the development of the strategy) and "front running" (in which investors outside of a fund are able to place trades ahead of the fund).[26] Requiring such public disclosure also risks severe damage to the value of the administrators' intellectual property and index licenses.[27] And finally, as discussed in more detail below, imposing such costs on index providers could harm investors by reducing competition and stifling the development of new and innovative market indices. These costs and negative consequences are not justified by any potential benefits, as this level of public disclosure is unnecessary to enable users to assess the credibility, representativeness, relevance, and suitability of a benchmark on an ongoing basis.

Conclusion—the Costs of Unnecessary Regulation

The fact that reforms are needed in the LIBOR context does not, in and of itself, suggest that those same reforms are necessary or appropriate with respect to *all* securities indices or the firms that sponsor or administer them. The imposition on market indices of unnecessary regulations is not just an issue for index administrators, but also for regulated funds that license the use of their indices and ultimately, their investors. Regulation has the potential to increase costs, which would be passed through to the funds in the form of higher license fees, increasing fund expenses that ultimately are paid by fund investors. Increased regulatory costs also would raise barriers to entry in the index administration business, reducing competition and stifling the development of new and innovative market indices and indexing techniques—to the detriment of index licensees and ultimately fund investors.[28]

The Consultation identifies a number of important considerations regarding the quality and integrity of a benchmark's methodology, the ability of market participants to understand a benchmark, the potential for conflicts of interest or other weaknesses, and the presence of a governance or oversight structure to identify and mitigate such conflicts or weaknesses. These are legitimate concerns, but we strongly urge the Task Force to resist treating the entire, diverse universe of benchmarks and commercial indices together. It should treat benchmarks and commercial indices separately, identifying in each instance whether potential issues exist and, if so, whether a regulatory approach is necessary.

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[24] Principle C.6 in the Consultation

[25] Principle C.1. in the Consultation

[26] *See, e.g.,* 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 at page 26 and note 42 (discussing the potential detrimental impact of real-time portfolio disclosure on fund investors).

[27] *See, e.g.,* letter from MSCI in Response to the European Commission Consultation on the Regulation of Indices, available at http://ec.europa.eu/internal_market/consultations/2012/benchmarks/individual-others/msci_en.pdf (stating that "equity indices constitute intellectual property which is protected by national and international laws and conventions," and warning the EC that "regulation that requires index providers to make their intellectual property (for which they normally charge a fee to access) freely available without restriction, allowing others to free-ride, could result in index providers exiting the European market").

[28] For a more detailed discussion of the potential costs of unnecessary regulation of index providers, *see* letter from Vanguard in Response to the European Commission Consultation on the Regulation of Indices, available at http://ec.europa.eu/internal_market/consultations/2012/benchmarks/individual-others/vanguard_en.pdf.

We appreciate the opportunity to provide comments on the Consultation. If you have any questions about our comments or would like additional information please contact me (dan.waters@iciglobal.org or +44 203 009 3101) or Giles Swan, Director of Global Funds Policy (giles.swan@iciglobal.org or +44 203 009 3103).

Yours Sincerely,

/s/

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