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The International Organization of Securities Commissions (IOSCO) Consultation Report titled “Financial Benchmarks” (CR01/13, January 2013) was prepared by IOSCO Task Force on Financial Market Benchmarks (hereafter, the Task Force).

The report aims to articulate “policy guidance and principles for Benchmark-related activities” to address concerns regarding the potential integrity of benchmarks and maintain confidence in the credibility of benchmarks.

To inform its final Principles on Financial Benchmarks, IOSCO seeks the views of stakeholders on the questions posed in this report.

Having called for such work be conducted by IOSCO (in Amenc and Ducoulombier, 2012b), EDHEC-Risk Institute welcomes the opportunity to comment on IOSCO’s efforts to create “an overarching framework of principles for Benchmarks used extensively in financial markets.”

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Preliminary disclosure

EDHEC-Risk Institute is the finance research centre of EDHEC Business School, a not-for-profit academic institution present in France, Singapore and the United-Kingdom.

Founded in 1906, EDHEC Business School has 6,000 students in degree programmes and 134 permanent faculty members. Its 24,000 alumni are present in 116 countries. EDHEC Business School has earned all-three major international accreditations for its programmes (AACSB, EQUIS, AMBA). It is registered with the French Ministry of Education and its Singapore-headquartered subsidiary, EDHEC Risk Institute—Asia, is registered with the Singapore Council for Private Education¹ EDHEC Business School aims to be recognised for research and training, innovative ideas and tools that have a high impact on businesses.

EDHEC-Risk Institute was set up to conduct world-class academic research and highlight its applications to the pensions and investment industry. The Institute's team of 90 permanent professors, engineers and support staff, together with 45 research associates from the financial industry and affiliate professors implements six industry-supported programmes focusing on asset allocation and risk management in the traditional and alternative investment universes. In

¹ Registration No.201025256Z, valid from 22-06-2011 to 21-06-2017.

keeping with its mission, the centre systematically seeks to validate the academic quality of its research through publications in leading scholarly journals, implements a multifaceted communications policy to inform investors and asset managers on state-of-the-art concepts and techniques, and develops business partnerships to launch innovative products.

EDHEC-Risk Institute has been conducting academic research on indices and benchmarks for over ten years; it has also designed commercial and non-commercial indices for a variety of asset classes and strategies. EDHEC-Risk Institute has also contributed to and commented upon the European Securities and Markets Authority's (ESMA) and IOSCO's recent work on ETFs and other collective investment vehicle issues, calling for new transparency and governance requirements for financial indices.

EDHEC-Risk Institute and index provider FTSE jointly offer the FTSE EDHEC-Risk Efficient Index Series. EDHEC-Risk Institute has designed the alternative weighting scheme methodology for this series and is responsible for the calculation of the weights. The rest of the methodology and the management of the index series conform to the FTSE Global Equity Index Series Ground Rules and FTSE are responsible for the operation of the index series. Rules for the calculation and publication of the index series are those defined by FTSE. The complete weighting scheme methodology is available free of charge on FTSE's website but rules for data licensing are those defined by FTSE. EDHEC-Risk Institute has no influence on the rules defined by FTSE.

In order to help investors understand the main features, benefits and risks of so-called "smart beta" indices, the Edhec-Risk Institute will launch in 2013 a series of initiatives aiming at improving their transparency and efficiency. As such, in the second quarter of 2013, EDHEC-Risk Institute will be making available to investors and managers a platform of replicable equity indices created from the most popular diversification methods. The information on the returns and compositions of this platform's flagship indices will be accessible free of charge.

Preamble: on the prevalence and relative importance of conflicts of interest and the paramount importance of transparency

The Task Force devotes considerable attention to conflicts of interest in this Consultation Report, attempting to identify how options in the areas of Methodology, transparency, governance, accountability and roles and responsibilities of Benchmark Administrators (index providers) can exacerbate or mitigate these conflicts.

While best practices should be recognised and promoted, it would be wrong to accept the idea that the status of an index provider could by itself be a guarantee against conflicts of interest. Conflicts of interests exist across the Benchmark provision industry and it would be illusory to believe that regulation targeting practices or stakeholders could make them disappear. On the contrary, any false distinction or false certification² that would be organised or condoned by the regulator would potentially be more dangerous than potential conflicts of interest. By this regard, we consider that condemning self-indexing out of hand or tolerating that some index providers style themselves as independent promotes moral hazard and adverse selection phenomena. It is not the existence of conflicts of interest that is most troublesome, but the illusion that they have been dealt with and the fact that (would be) index users do not have sufficient information to perform their due diligences on the quality and integrity of Benchmarks.

² False in the sense that such distinction or certification would not correspond to material differences in risk.

In the same spirit, we feel it would be very dangerous and counterproductive to design future Benchmark regulation so as to make the index provision profession more difficult and costly through capital requirements or the implementation of liabilities on the material consequences of errors committed by Benchmark Administrators. It is clear that imposing barriers to entry into the index provision market would not encourage its efficiency either in terms of price or of quality.

We think that there is a major risk that regulation on the status and means of index providers may restrict competition and ultimately lead to an oligopoly of the kind existing in the credit rating industry.

On the contrary, it is by strengthening competition through the liberalisation of the use of indices' historical data—which should be considered public and non-protectable data—that high-quality index offerings, in scientific and technical terms and in terms of information to investors, will genuinely be able to develop. In this sense, we wish to stress how much the new guidelines of the European Securities Market Association (ESMA) on the use of financial indices by European harmonised retail investment funds are an important step towards the desired level of transparency and efficiency in the index provision industry, and therefore towards investor protection.

As economists, we are convinced that the best way to improve the quality of indices is to increase the amount of available information. In our opinion, no governance mechanism or regulation of index providers will ever replace the due diligence of investors, which itself is facilitated by the possibility to avail of reliable and transparent information on the indices, and of course by the availability of critical research provided by all market stakeholders, which itself can be challenged.

We underline the importance of developing index transparency for the index market itself. We do not think that this transparency will be detrimental to index providers and it should not be seen as a constraint but as an opportunity. Indices are an essential ingredient in asset management. EDHEC-Risk Institute is supporting and participating in a significant trend both in academic research and the investment industry which aims to question the added value of traditional active management to the benefit of an approach involving new forms of indexation and construction of better diversified, and therefore more efficient, Benchmarks. It is clear that the innovations in the area of indexation proposed in recent years not only by index providers, but also by asset managers and investment banks, are genuinely useful for investors. It would be a shame if a lack of transparency led to distrust of these innovations. We believe it is in the interest of all stakeholders that the momentum of a market which is based on research and new offerings whose track records are necessarily simulated, be maintained by avoiding a situation where investors are unable to prove the offerings' out-of-sample robustness due to a lack of information that is reliable and open to criticism.

General comment: on the characteristics of a Credible Benchmark

The Task Force considers that Benchmarks should have the following characteristics in order to be credible:

- Representative: a Benchmark should clearly convey the economic realities of the underlying interest it seeks to measure to its users;
- Reliable: the data relied upon to construct the Benchmark should be sufficient to represent that interest and the data should be bona fide;
- Transparent: there should be sufficient transparency over the Methodology, calculation and inputs to allow users to understand how the Benchmark is derived and its potential limitations; and
- Subject to clear governance and accountability mechanisms.

With respect to these characteristics, we wish to make three comments:

Comment #1 on the need for a Benchmark to be representative: strategy indices which aim to achieve a given risk/return objective have emerged besides traditional market indices which aim to be representative of a market or market segment. For the sake of generality, we would thus recommend that all Benchmarks be required to disclose their objective(s) along with the detailed metrics that allow for assessing the achievement of these objectives, be they to represent underlying economic realities or to achieve a given risk/return objective.

Comment #2 on the adequate level of transparency: requiring a level of transparency that aims at ensuring that (would-be) users understand how the Benchmark is derived and what are its potential limitations is to us an absolute minimum rather than an ultimate goal. We consider that the necessary level of transparency is one allowing (would-be) users to independently replicate the Benchmark published track record so as to verify how the Benchmark Methodology is implemented, measure the extent of discretion exercised in the past, and conduct the due diligences on the performance and risk characteristics of the Benchmark that are required to assess the relevance and suitability of the Benchmark against the specific goals of a given user. This implies complete transparency not only of Methodology but also of historical Benchmark composition.

Comment #3 on governance and accountability mechanisms: while we agree that clear governance and accountability mechanisms are tools that can promote Benchmark integrity, we consider these to be third order priorities. The provision of full and complimentary transparency of Methodology and historical Benchmark composition is the most powerful mitigator of conflicts of interest and second to it is the existence of a credible control framework. Governance mechanisms are not exempt of conflicts of interests themselves and have proven incapable of averting major scandals. Likewise code of ethics and standards of conduct promulgated by professional associations have proven insufficient to instil strong ethical cultures within financial companies or prevent the recent crisis and associated loss of trust by the public. Governance mechanisms, codes and standards are at best of third order importance and at worst dangerously counterproductive due to the moral hazard and adverse selection phenomena that they encourage. They should thus be used as support of, rather than alternatives to, full transparency and strong control frameworks and we strongly caution against any temptation to trade lower levels of transparency (and/or a laxer control framework) against stronger governance mechanisms or stricter codes and standards.

Specific comments

Foreword

Our recent research having focused on Benchmarks that are based on data for transactions recorded on exchanges, we have limited expertise on issues regarding (i) information submission and Submitters, (ii) data sufficiency and transition. Against this backdrop, we will not be providing answers to Consultation Questions focused on these.

Chapter 1 Introduction

Question 1: *Do you agree with the scope of the report and intended audience? Are there other Benchmarks or stakeholders that have idiosyncrasies that should place them outside of the scope of the report? Please describe each Benchmark or stakeholder and the idiosyncrasies that you identify and the reasons why in your view the Benchmark or stakeholder should be placed outside of the scope of the report.*

We agree with the scope and focus of the report i.e. the risks to the credibility of Benchmarks and risks to users arising from the Benchmark’s Methodology, transparency and governance arrangements.

In our recent public comments to the ESMA consultation on its guidelines on Exchange Traded Funds (ETFs) and other UCITS issues (Amenc and Ducoulombier, 2012a) and the IOSCO consultation on principles for the regulation of ETFs (Amenc and Ducoulombier, 2012b), we underlined the need for transparent and systematic index methodologies and methodology implementation to protect the integrity of indices. Having then recommended that (ESMA and) IOSCO “start working on these issues and launch a consultation on indices and indexing that will pave the way for major progress in the information of index-tracking vehicles and end-investors with respect to the quality, governance, and auditability of indices,” we welcome the present consultation and agree with its scope and focus.

With respect to the intended audience of the report, we note that the “users of benchmarks” have not been precisely identified and take this as an indication that IOSCO intends the audience of users to be as large as possible.

In our recent contribution to the European Commission Consultation on the Regulation of Indices (Amenc and Ducoulombier, 2012c), we stressed that indices are commonly used as benchmarks in a more general way than that described by the proposed European legislation and that these other uses can have significant impact on the economy or the welfare of investors and citizens.

Indices can serve as references for passive and active investment products whereby an asset manager attempts to replicate the performance of an index or deliver performance that is superior to that of the index. The performance of the product relative to the index will be one of its key success factors on the market. In passive management, minimising the performance differential or tracking error³ will measure the quality of index replication; indices tracked will include market indices (which aim to be representative of a market or market segment) and strategy indices (which aim to achieve a given risk/return objective). Active management will be

³ The volatility of the performance differential.

assessed through its ability to deliver positive performance relative to the index.⁴ Relative performance will affect an active manager's compensation, directly via the imposition of performance fees and indirectly via flow of investor funds effects and the imposition of fees linked to assets under management. We should also underline that the compensation structure of index providers which license market and strategy indices to asset managers for use as underlying typically includes a variable component that is proportional to the assets under management; in recent years the index provision industry has been reshaped by the growth of lucrative licensing along the traditional model of lower margin data provision.

Indices are also used to proxy the performance of asset classes and strategies in the context of asset allocation exercises by institutional investors and by a wide variety of stakeholders that use index values as inputs to financial models for the valuation of claims and the hedging of risks.

This variety of uses for indices and benchmarks points to a variety of users. We consider that IOSCO has intentionally avoided the use of a restrictive list of users to maximise the targeted audience.

Chapter 2 Discussion of Potential Issues

A. Methodology

Question 2: Do you agree that the design of a Benchmark should clearly reflect the key characteristics of the underlying interest it seeks to measure?

We agree that the design of an index should take into account the characteristics of the “underlying interests” (e.g. size and liquidity, transparency, concentration or dynamics of markets) with a view to prevent or mitigate index integrity issues.

We agree that design of an index should correspond to its stated objective(s) and recommend that index providers be required, on a complimentary basis, to clearly disclose the objective(s) of each of their indices along with the detailed metrics that allow for assessing the achievement of these objectives and the historical track record of these indices with respect to achievement of these goals. If several objectives are identified for an index, a clear hierarchy of objectives should be disclosed.

Our formulation is couched in general terms to recognise that strategy indices which aim to achieve a given risk/return objective have emerged besides traditional market indices which aim to be representative of a market or market segment.

The disclosure of company objectives is a well established corporate governance requirement for all companies, and the disclosure of objectives is also required of investment companies and funds; for example, “a short description of investment objectives and investment policy” is one of the “essential elements” that European harmonised retail investment funds (known as

⁴ As remarked by the Kay Review (2012): “The decisions of asset holders to hire and review asset managers are typically based on their performance relative to index benchmarks, or their performance relative to other asset managers in a defined category. This emphasis on relative performance is found at every point in the investment chain. Advertising to retail customers stresses the relative performance of the promoted funds. Financial intermediaries give advice on a similar basis. Asset holders hire managers by reference to their recent performance relative to other similar managers, and are guided in this choice by consultants who construct databases for this purpose, and then monitor asset managers via benchmarks. The central role of relative performance in the business models of asset managers is mirrored in the bonus structures applied to individual fund managers within asset management companies.”

undertakings for collective investment in transferable securities or UCITS) are required to provide in their Key Investor Information Document.

While regulators have for long imposed restrictions on what types of indices could be used by index funds, the requirements to be met for an index to be acceptable were relatively high-level; a 2004 IOSCO report on index funds and the use of indices by the asset management industry abstracts these in three characteristics: (i) wide recognition and acceptance; (ii) wide dissemination and availability of public information about composition and methodology; and (iii) sufficient diversification (IOSCO, 2004). It is only recently, in the wake of concerns fuelled by the growth and diversification of indexing products and interbank rate benchmark rigging scandals that indices have received closer scrutiny.

After one year of research and consultations that had initially polarised along possible issues with index-tracking ETFs, ESMA released guidelines providing guidance on the information that should be communicated with respect to index-tracking UCITS and set out criteria that should be respected by financial indices in which UCITS invest (ESMA, 2012). ESMA stresses that indices used by UCITS for investment purposes should satisfy the index criteria in (Article 53 of the UCITS Directive and) Article 9 of the Eligible Assets Directive (EC, 2007) and clarifies requirements with respect to index objective and transparency by stating that an index should have “a clear single objective” in order to represent an adequate benchmark for the market and that the “universe of the index components and the basis on which these components are selected for the strategy should be clear to investors and competent authorities.”⁵ ESMA has also required UCITS to carry out “appropriate documented due diligence” on the quality of indices which they wish to use. Consistently with the above, this process should notably take into account “whether the index methodology contains an adequate explanation of the weightings and classification of the components on the basis of the investment strategy and whether the index represents an adequate benchmark.” It should also assess whether “there is a clear narrative description of the benchmark” (ESMA, 2012).

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In its recent consultation document on the production and use of indices, the European Commission suggested that a benchmark index should state a “clear and transparent specification of what the benchmark measures, how its accuracy can be evaluated, what its shortcomings are and what it should and should not be used for” (EC, 2012).

Likewise, the Task Force has contended that, to be credible, benchmarks should be representative, reliable, transparent and subject to clear governance and accountability mechanisms. “Representative” refers to the benchmark’s ability to “clearly convey the economic realities of the underlying interest it seeks to measure”; “Reliable” refers to the data used to construct the benchmark being “sufficient to represent that interest” as well as bona fide; “Transparent” refers to a level of transparency over the “Methodology, calculation and inputs” that would be sufficient “to allow users to understand how the Benchmark is derived and its potential limitations.” The Task Force underlines that: “It is important that the key terminology in the Benchmark is clearly defined as well as the Benchmark’s objective. The user should understand clearly what the Benchmark is trying to represent, and how the inputs are obtained and the outputs derived” (IOSCO, 2013).

⁵ Beyond that, ESMA required that index calculation methodologies as well as index constituents and weightings be easily and freely available to investors and prospective investors, information that is required to check how index ground rules are implemented. ESMA also required UCITS to carry out due diligence on the quality of the financial indices they use and prohibited investment in indices whose methodologies are not based on a set of pre-determined rules and objective criteria.

Indices may have a variety of objectives, such as representing the economy of a certain country or region, minimising the total volatility or providing an exposure tilt toward a risk factor⁶. To orient would-be users with respect to the purpose of a given index, a basic requirement is thus for the single objective or hierarchy of objectives to be disclosed without any room for confusion. However, statement of a clear single objective or hierarchy of objectives is not always present in index documentation and index marketing material in a broad sense may add to the confusion by mentioning or implying other objectives (see for example, Amenc, Goltz and Le Sourd 2008a and 2008b).

We consider that a clear statement of the objective(s) of a Benchmark along with high level information on index construction principles can provide first orientation as to the relevance and suitability of a Benchmark for a (would be) user. Against this backdrop, we recommend that index providers be required, on a complimentary basis, to clearly disclose the objective(s) of each of their indices along with the detailed metrics that allow for assessing the achievement of these objectives and a formal assessment of the qualities that the index achieves ex post against the stated objective(s). If several objectives are identified for an index, a clear hierarchy of objectives should be disclosed.⁷

Question 3: What measures should Administrators take to ensure the integrity of information used in Benchmark-setting and that the data is bona fide? Please highlight any additional measures required where Benchmarks are survey based. Please also comment on each of the factors identified in the discussion on the vulnerability of data inputs such as voluntary submission, and discretion exercised by Administrators. Are these measures adequately reflected in the discussion of roles and responsibilities of the Administrator discussed in section E?

We trust the Task Force has correctly identified discretion in methodology and opacity of methodology or discretionary decisions as threats to Benchmark integrity. Whenever data integrity can be tampered with, or discretion can be exercised in data processing, conflicts of interests that may concern parties involved in the production of a Benchmark increase the risk of misconduct that will impact the integrity and therefore the reliability of the Benchmark. Even in the absence of conflicts of interest and misconduct, incompetent use of discretion will negatively impact index integrity and unchecked exercise of discretion may render an index unreliable.

Against this backdrop, our recommendations are (i) to rely on transaction based approaches and comprehensive public data that from central repositories whenever this is allowed by the index objectives and the characteristics of the “underlying interests”; (ii) to minimise the extent of discretion that can be exercised at all steps of the Benchmark production process and require the disclosure and explanation of instances of discretion.

We agree with IOSCO that with respect to input and input selection: “some Methodologies are less prone to conflicts of interest, some are more able to provide an accurate and stable representation of the market, and others provide more resilience to market stresses.” We also agree that with IOSCO that “No methodology is immune from attempts to manipulate the

⁶ Exposure to a risk factor, such as one of the Fama and French (1993) factors, can be achieved through a set of methods involving stock selection and weighting and can be measured in terms of statistical sensitivity to the targeted and identified risk set of variables.

⁷ Stating a clear and measurable set of objectives is also a way to signal to investors what is (are) the goal (s) the index will need to fulfil and for which its provider will be accountable for in terms of transparency and achievement. Still, declaring one particular (set of) objective(s) does not prevent index investors to look at alternative uses of the product.

Benchmark – especially where the conflicts of interests are not mitigated, and the Benchmark setting process lacks transparency.”

The production of an index for a defined purpose requires a process for data identification, data collection, and data processing up to computation of the index.

What data is to be collected should be determined by analysing the objective of the index and should provide sufficient basis to build a reliable indicator of what the index is meant to reflect. The underlying data maybe as objective and verifiable as actual transaction data reported by a regulated trading venue subjected to strong regulation and oversight⁸ and as subjective and subject to caution as unaudited figures, estimates or opinions provided by a stable or variable sample of data contributors who participate on a voluntary basis and may even be in a position to choose when and what to report, while being aware that such reporting is not a regulated activity. When central data reporting e.g. of transactions is mandatory, data collection is easy provided access is granted to the central data repository. When there is no requirement for central reporting, the data collector may choose to rely on one or several venues where data is concentrated and can be accessed e.g. organised markets where transactions are executed, survey participants e.g. major broker-dealers, intermediaries and/or end-investors. Whenever comprehensive data cannot be obtained from a central repository, there will be questions on the representativeness of the sample of data collected.

Once data has been collected, it may be filtered by the Administrator e.g. to exclude aberrant observations that could exert undue influence on the index, and then is aggregated e.g. by weighting to produce an index figure that should be representative of what the index is trying to measure.

Data identification, collection and computation may be more or less scientific, objective and verifiable – the methodology of an index should describe what data is to be collected and from whom, how data will be collected and how the index will be calculated. The systematic nature of each of these steps will vary: the extent of discretion exercised at every step may or may not be acknowledged explicitly; the basis and criteria for discretionary decisions may or may not be presented; and instances of discretion may or may not be documented, justified and disclosed to index users and would be users.

We have the noted the remarks of the Task Force linking the complexity of a calculation methodology with possible issues of transparency. We consider that ease of understanding should not be mistaken for transparency and wish to underline that we do not take exception about the sophistication of an algorithm as long as the level of transparency provided allows for an independent replication of the index. Any algorithm is preferable to the exercise of discretion: understanding an algorithm, unlike guessing how the Benchmark Administrator will make discretionary decisions, may sometimes require advanced mathematical or statistical skills but does not require clairvoyance.

Whenever data integrity can be tampered with or discretion can be exercised in data processing, conflicts of interests that may concern parties involved in the production of an index increase the risk of misconduct that will impact the integrity and therefore the reliability of the index. Even in the absence of conflicts of interest and misconduct, incompetent use of discretion will negatively impact index integrity and unchecked exercise of discretion may render an index unreliable.

⁸ Market manipulation will typically be more difficult and will fall under market abuse regulation.

Against this backdrop, our recommendations are (i) to rely on transaction based approaches and comprehensive public data that from central repositories whenever this is allowed by the index objectives and the characteristics of the “underlying interests”; (ii) to minimise the extent of discretion that can be exercised and require the disclosure and explanation of instances of discretion.

B. Transparency

Question 5: *What level of granularity with regard to the transparency of Methodologies would enable users to assess the credibility, representativeness, relevance and suitability of a Benchmark on an on-going basis and its limitations with respect to their intended use? Relevant factors could include; criteria and procedures used to develop the Methodology, type of data used, how data is collected, relative weighting of data used, how and when judgement is used, contingency measures (e.g., methods when transaction data is unavailable, etc.), publication of information supporting each Benchmark determination, etc. Please provide examples where you consider there are currently significant gaps in the provision of this information.*

Question 6: *What steps should an Administrator take to disclose to Market Participants and other stakeholders the contingency measures it intends to use in conditions of market disruption, illiquidity or other stresses?*

Question 7: *What steps should an Administrator take to notify Market Participants of material changes to a Benchmark Methodology (including to Benchmark components) and to take their feedback into account?*

The Task Force recommends that “The Methodology criteria, processes and policies which govern the construction of the Benchmark should be clearly defined and transparent (...) on a fair and non-discriminatory basis (including being free of charge). Transparency should be sufficient to allow interested parties to understand how a Benchmark is derived (including the ability to replicate a published Benchmark level to assess its plausibility and detect inaccuracies or potential manipulation), what it measures and therefore understand the suitability of the Benchmark for their purposes and any limitations or risks of the Methodology.”

With respect to granularity, we consider that to enable (would be) users to “assess the credibility, representativeness, relevance and suitability of a Benchmark,” it is necessary that the benchmark Methodology be fully transparent so as to allow for independent replication of the index by (would be) users for *any* published Benchmark level. Independent replication enables a (would be) user to audit the track record of the Benchmark, gauge the systematic character of the Methodology and of its implementation and conduct performance and risk analyses to assess the relevance and suitability of the Benchmark against its specific goals, e.g. investment goals.

Against this backdrop, we consider that index providers should be required to provide full and complimentary transparency on the detailed methodology of each of their indices. This covers identification of the universe of candidate components, selection and weighting of components, calculation of index in ordinary and extraordinary circumstances, and procedures for revision of methodology. While the Task Force stresses that transparency is “especially important” when the Benchmark does not solely rely on transaction data, we consider that it crucial for all Benchmarks.

Furthermore, Index providers should be required, on a complimentary basis, to provide complete historical information on the values, constituents, and weights of their indices as well as documentation describing the basis for and justification of each discretionary decision and change of methodology.

Particular attention should be given to indices whose track records include simulated data and it should not be possible for a Benchmark to be advertised on the basis of performance data that cannot be fully replicated in the conditions above.

The above recommendations are meant to provide interested parties with the track record of indices along with all the information required to independently verify this track record, assess the systematic character of the indices, and conduct further due diligences as they see fit. Regulators should further ensure that all interested parties, including competitors, enjoy the right to freely use this data for purposes of academic research, index evaluation and performance comparisons. This will not only allow asset managers and end-investors to perform their due diligences at minimal cost, but also foster the development of third-party research that will contribute to market efficiency. This will require clarification that those claiming property rights on an index have no basis to restrict the aforementioned uses.

The above disclosures should be normalised by regulators to ensure integrity and comparability of indices. When an index is used as underlying or performance benchmark for a regulated financial instrument or activity, these disclosures should be filed with, and become available to interested parties from the regulator via a service in the spirit of the Securities and Exchange Commission’s Electronic Data Gathering, Analysis and Retrieval (EDGAR) system. Retrieval and use of data from this service should at least be on the same bases as those described in the previous provision.

ESMA has barred UCITS from investing in financial indices for which, inter alia, the full calculation methodology to enable replication by investors is not disclosed; and/or the rules for the selection and the re-balancing of constituents are not pre-determined and based on objective criteria; and/or data on constituents and weightings is not available on a complimentary basis (ESMA, 2012). We consider that these high standards could be transposed to funds and non-fund investment products and to contracts with potential substantial impact on the welfare of investors and citizens.

Indices are typically marketed based on their transparency and their systematic nature, and users see these properties as a defining principle of indices. A rules-based approach to index construction and computation, alongside transparency of index rules, is key in allowing for the replicability of an index by (would be) users. Replicability will allow (would be) users to conduct their due diligences and the level of transparency demanded by replicability will also reduce potential conflicts of interest.⁹ The recent European Commission Consultation Document on the regulation of indices rightly observes that “increasing the transparency of any input data and the calculation of the index - in particular where discretion is exercised - will increase confidence in benchmarks, reduce the scope for abuse and ensure that users are adequately informed to make any decisions about whether and how to use an index” (EC, 2012).

Strategy indices arguably deserve to be subjected to stricter disclosure requirements than market indices; while such indices can potentially provide investors with improved risk to reward profiles

⁹ Discretion increases the risk of misconduct and 74% of participants in our recent European Index Survey (Amenc, Goltz and Tang 2011) report avoidance of discretionary decisions as important within the index construction process. Transparency when discretion is exercised, through documentation and justification, reduces misconduct opportunities. In any case, when there is room for discretion, it will be difficult for an index user to anticipate future decisions and properly evaluate risks.

(Amenc, Goltz, Martellini and Ye 2011) or other benefits, they bring distinct risks of their own, notably the risk of periodic underperformance vis-à-vis market indices, which to this date remain the primary benchmarks (Amenc, Goltz and Lodh 2012).¹⁰ Furthermore, while they are often several providers offering indices with comparable objectives, closer inspection reveals the wide diversity in methodologies (e.g. for screening the universe, estimating model parameters, weighting components, etc.) and therefore different model risks for competing offers, as well as a high level of opacity on detailed methodology, justified by the use of proprietary models, which makes the evaluation of such risks difficult.

To understand the risks of these indices and make informed investment choices, investors need to understand the objectives of these indices and their underlying conceptual assumption and conduct a thorough examination of their risk and return characteristics on the basis of a track record that can be verified to represent the systematic implementation of a transparent methodology to point-in-time data (with any instance of discretion suitably disclosed and justified).

In the light of the growing importance of indices in investment management and the emergence of new forms of indices, we have repeatedly called for transparency to be provided by index providers¹¹ or to be imposed by regulators in case of failure of self regulation.

By transparency, we mean the availability of clear summary information disclosing the objectives of an index and its key construction principles, of detailed information on the index construction and calculation methodology, and of data on index constituents and weights.

When considering indices as underlying, such information is required to allow investors to screen indices for relevance in the context of their investment objectives and constraints¹²; to independently calculate the track records of indices in terms of risk and performance¹³; and to assess whether the index is managed in a systematic manner.¹⁴

The quality of indices deserves comparable scrutiny when they are used as performance benchmarks or as inputs to financial models that support the allocation of assets, the valuation of claims, or the management of risks.

ESMA has recently required from UCITS that they ensure that (would-be) investors have free and easy access to the full calculation methodology, constituents and weights¹⁵ of each index in which the UCITS is invested¹⁶ as well as free access to performance information. It has also

¹⁰ Cap-weighted indices have no equivalent when it comes to representing market movements, and they remain the simple reference understood by all investors and stakeholders in the investment industry.

¹¹ FTSE and EDHEC-Risk Institute jointly offer the FTSE EDHEC-Risk Efficient Index Series. EDHEC-Risk Institute has designed the alternative weighting scheme methodology for this series and is responsible for the calculation of the weights. The rest of the methodology and the management of the index series conform to the FTSE Global Equity Index Series Ground Rules and FTSE is responsible for the operation of the index series. Rules for the calculation and publication of the index series are those defined by FTSE. The complete weighting scheme methodology is available free of charge on FTSE's website but rules for data licensing are those defined by FTSE. EDHEC-Risk Institute has no influence on the rules defined by FTSE.

¹² In this context some of the questions to ask are: Does the index have a clearly stated objective? If so, is that objective measurable and are metrics provided to gauge the performance of the index relative to its objective? Are historical risk-and-return characteristics provided? If so, is the index profile appropriate with respect to the investor's objectives and constraints?

¹³ In this context, some of the questions to ask are: How sensitive are summary statistics provided to the choice of period? What are the risk drivers of this index? What is the risk and return record of the index according to the specific metrics used by the investor and how stable is it across periods? How does investment in this index affect the overall risk-return profile of the investor?

¹⁴ Here, some of the questions to review are: How much explicit or implicit discretion is provided to those calculating the index or those choosing and weighting index components? Can the index track record be reconstructed by systematic application of the index ground rules? Is the basis for index changes and supporting documentation provided? How are changes to ground rules managed? Is there any difference in the application of rules in the backfilled vs. the live period of the index? How comfortable is the investor with the level of discretion and subjectivity displayed by the management of the index over time?

¹⁵ Weightings may be published after each re-balancing on a retrospective basis.

¹⁶ Notably including detailed information on index constituents, index calculation, re-balancing methodologies, index changes.

barred UCITS from investing in indices whose component selection and weighting methodology is not based upon “pre-determined rules and objective criteria” and demanded that UCITS carry out due diligence on the quality of the financial indices they use (ESMA, 2012). One of ESMA’s key objectives with these new requirements is to restrict UCITS’ choice of indices to those that are built and managed in a systematic manner and for which index providers make available sufficient information to the public to allow for independent replication on a non-commercial basis, which is a precondition for informed investment decisions.

ESMA’s is a landmark decision that will reshape the index provision industry, which heretofore had been providing only limited information to investors under the pretext of protecting intellectual property. As we had underlined in our exchanges with ESMA (Amenc and Ducoulombier, 2012a), this information was difficult to obtain for traditional (i.e. market) indices, even though the rules of the latter are typically simple, and almost impossible to procure at reasonable cost in the case of strategy indices.

We recently studied 50 equity indices against to gauge the current degree of opacity and extent of discretion in the index provision industry. The objective was to assess the gap between current practices and the objective of systematic and transparent indices which has been defined by regulators and index users alike.

With respect to index replicability, we looked at the following: (i) disclosure of detailed construction methodology with respect to component selection and weighting and index calculation in the presence of corporate actions¹⁷, and systematic nature of the methodology; (ii) availability of methodology used for back-tests, hindsight biases introduced, and disclosure of differences between back-testing and live period methodologies; (iii) availability, ease of access, and cost of current and historical index constitution data.

What emerges from this analysis is that (i) methodologies as described in the index ground rules typically leave considerable explicit or implicit room for discretion at multiple levels; (ii) only minimal disclosures are made with regards to back-tests and when information can be obtained, it shows significant potential for upwardly biased performance in historical simulations; (iii) last but not least limited information beyond current constituents is available at no cost and the costs of acquiring the information required to conduct risk and performance analyses is typically non-trivial.¹⁸

Our observations on the transparency of methodologies are consistent with those of the Task Force which observes that the majority of the Benchmarks it had reviewed “published their Methodologies but did not always provide enough detailed information to allow users to recreate

¹⁷ Corporate actions include events such as dividends, rights issues, share buybacks, stock splits, mergers and acquisitions. They require adjustments in the index and can have a significant impact on the computed index values, hence the need for detailed attention for index rules for dealing with these. Typically, index providers disclose how a particular corporate action is being dealt with. However, if treatment is systematic, such disclosures are redundant.

¹⁸ For 94% of the indices in the analysis, providers stated that a payment was required to access historical data; the necessary historical information on one index (2%) was available free of charge on the provider’s website; the historical information was not available on another index (2%) and for yet another index (2%), no information could be sourced from the provider. In sourcing data, we observed considerable heterogeneity in the methods of data access and in the pricing structures offered by index providers in the context of their data services. Notably, the number of indices included in the minimum subscription and the minimum number of periods or the minimum length of a series varied from one index provider to the next. For instance, one index provider allowed the purchase of historical data per index, whereas others required the purchase of a data package which included access to data for a range of indices. Likewise, some index providers were selling their historical data on a monthly basis, while others (in fact most of them) were imposing the purchase of yearly minimal subscriptions. Without a standard pricing model, the costs of accessing historical data are not directly comparable across index providers. This cost can nevertheless be pretty steep with some minimal annual subscription listed as high as EUR12,000 (with full history on all of the indices offered by that provider) or USD12,000 (for five years of history on all the indices offered by that provider).

Benchmark outputs based on information held by the Administrator.” A key insight from our study of index transparency is that there is heterogeneity across indices and considerable room for improvement in terms of the transparency and systematic character of indices. Indeed, for each of the transparency criteria we assessed, we found some of the indices fulfilling the given criterion and other indices not fulfilling it. Moreover, indices that fulfilled transparency criteria in one area did not necessarily fulfil the criteria in other areas. While there were differences across criteria in the sense that some of them were fulfilled by a large majority of indices while others only by a small minority of indices, there was no criterion that none of the indices could fulfil. This demonstrates that while there is (much) room for improvement for methodological transparency, such improvement is realistically achievable.¹⁹

While overall these results paint a very negative picture of the availability of the information that would allow investors to perform their due diligences, at least up to an independent verification of an index’s purported track record, it is interesting to remark that restrictions routinely imposed by index providers on the use of the information that is provided on a complimentary basis practically deny investors the right to perform simpler diligences. For example, terms of uses for data that is provided free of charge will typically state that the data is provided for personal non commercial use and may not be used to create any other data, works, charts, reports, etc. without prior authorisation of the index provider, and that that the data may not be reproduced, modified, or transmitted without prior authorisation of the index provider.

Also note that, when access to data is granted without stated terms of uses, which is the exception, applicable law may protect databases against the type of uses that would be required to perform due diligences.²⁰

In this context, (would-be) Benchmark users need to acquire costly licenses from index providers for the sole purpose of conducting their due diligences on Benchmarks whose use they are contemplating. Furthermore, with strategy indices, it is not unusual for access to the required data to be granted on a discretionary basis or not at all when the provider considers such data is too sensitive to be disclosed.

Restrictions on the availability or use of data also prevent the provision of research and analysis services and even academic research. In the area of strategy indices, there is an abundance of publications but a dearth of relevant research. Due on the one hand to the restriction in the access to information and on the other to the sales and marketing stakes represented by the validation in a scientific publication of the relevance and the robustness of a proposed model,

¹⁹ For example, only half of the indices in our study mentioned more than 7 types of corporate actions out of the 10 we considered as key for index replication (namely rights offerings, spin-offs, M&A, bankruptcies, delisting, early inclusions, suspensions, special dividends, stock splits and share repurchases). The mention of a type of corporate action is of course a minimal requirement when we assess whether index rules provide a full set of systematic rules that would allow an index user to verify the adjustments in the index that have been made for corporate actions. Likewise only half of the indices studied indicated the timing for more than two out of 10 corporate action types. Similarly, only half of the indices indicated precisely how the price used for the adjustment was determined for more than two types of corporate actions out of 10 types. Overall, the fact that more than half of the indices did not provide fully systematic rules for either the price or the timing of adjustments for most types of corporate actions may induce significant uncertainty on how the actual adjustments are to be undertaken. It is clear that some corporate actions are more complex than others and some discretionary adjustments can be justified to account for complexity or one-off events. Likewise, the absence of systematic rules can be somewhat alleviated by providing previews on the adjustments which will be undertaken, as is frequently done by providers. However, to be able to independently verify the track record of an index, it is clear that one requires fully systematic rules. It is interesting to note that some indices manage to include rules for a much greater number of events than their peers, suggesting room for improvement across the industry when it comes to providing systematic corporate action adjustment rules.

²⁰ For example Article 7 of European Directive 96/9/EC on the legal protection of databases states in its first paragraph: “Member States shall provide for a right for the maker of a database which shows that there has been qualitatively and/or quantitatively a substantial investment in either the obtaining, verification or presentation of the contents to prevent extraction and/or re-utilisation of the whole or of a substantial part, evaluated qualitatively and/or quantitatively, of the contents of that database.” and its fifth paragraph: “The repeated and systematic extraction and/or re-utilisation of insubstantial parts of the contents of the database implying acts which conflict with a normal exploitation of that database or which unreasonably prejudice the legitimate interests of the maker of the database shall not be permitted.”

index promoters exert undue influence on research in the area of strategy indices, authoring articles that cannot be challenged, and restricting innovation.

Free access for all to information allows for public debate on the strengths, weaknesses, benefits and risks of indices, which ultimately creates the conditions for a genuinely efficient index market. Moreover, new forms of indices are often marketed on the basis of simulated track records. The choice of models and the estimation of in-sample parameters should be questioned both in terms of accuracy and of out-of-sample robustness. This scrutiny cannot be exercised by the promoters of these indices, so it is important for researchers, investors and competitors to be able to avail of the required information to conduct these investigations.

Question 8: *How often should the Administrator review the design and definition of the Benchmark to ensure that it remains representative?*

Stability of risk factor exposure is required for a Benchmark to have relevance for long-term investment and changes to the design and definition of the Benchmark could buttress or damage this stability. Methodological revisions should thus be informed by objective metrics measuring the achievement of the Benchmark’s goal(s). Frequency of changes should not get in the way of Benchmark tracking.

C. Governance

Question 9: *The Consultation Report discusses a number of potential conflicts of interest that may arise at the level of the Submitters, between Submitters at different entities, and between Submitters, Administrators and other third parties. Are there other types of conflicts of interest that have not been mentioned that you consider may arise? If so, how best should these conflicts of interest be addressed? Are the measures discussed in the Consultation Report sufficient to address potential conflicts of interests at the level of the Submitters, between Submitters at different entities, and between Submitters, Administrators and other third parties?*

We trust the Task Force has correctly identified a number of potential conflicts of interests linked to private economic incentives and ownership or control structure; we offer our review below as a complement, focusing on conflicts of interests at the Administrator level.

With respect to conflicts of interests, we wish to dispel a common misconception about the inherent inferiority of self indexers vis-à-vis other index providers when it comes to the prevention of conflicts of interests. First, as observed by the Task Force, the ownership structure of index providers can pose inherent conflicts of interest. Furthermore, conflicts of interest can arise by virtue of the diversified portfolio of activities undertaken by index providers (this is analogous to the conflicts of interest faced by oil price reporting agencies as previously reviewed by IOSCO (2012a and 2012b).) Last but not least, the assets-under-management based licensing-fee model adopted by index providers aligns their interests with those of the investment managers tracking their indices. In this context, we consider that the distinction between self-indexers and other index providers is likely to mislead (would be) Benchmark users into believing that the latter entail a materially lower risk of manipulation. Condoning this false distinction could reduce the incentives for (would be) Benchmark users to perform

effective due diligences on the actual risks of Benchmarks offered by certain index providers and exacerbate adverse selection and moral hazard phenomena. From an investor welfare point of view, there may also be serious costs involved with limiting competition and innovation in the area of Benchmark provision.

Likewise, we consider that the use of the expression “independent index provider” should be either be banned outright or reserved to index providers whose ownership and control structures and other business operations do not create obvious internal or external conflicts of interest. In all cases, conflicts of interest should be identified, disclosed and managed.

With respect to the prevention and mitigation of conflicts of interest, we consider that the most potent measure discussed in the Consultation Report is the transparency of Methodology and historical Benchmark data and that the adequate granularity of transparency is one that allows for independent replication of the Benchmark over its published track record.

In any case, an effective control framework should be in place to minimise the likelihood that conflicts of interest will affect Benchmark integrity. The control framework should be transparent and should identify, manage and disclose conflicts of interest.

An investment manager should be authorised to self-index provided this is suitably disclosed and the investment manager either outsources Benchmark management to an independent party or puts in place an adequate control framework to protect the integrity of its in-house Benchmark management. Naturally, arrangements for the compensation of independent third parties, which would not necessarily be index providers, would need to be structured to minimise conflicts of interest.

Conflicts of interests in relation to index constituents

Conflicts of interests relating to the holding of privileged information by the index provider are well documented as well as understood by regulators and practitioners alike. Changes in constituents and constituent weightings have the potential to have price impact; as such they are valuable information as long as they remain private. Insider trading on the basis of this information would typically result in private benefits for the perpetrators at the expense of index users. The less systematic and transparent the index methodology, the more difficult it is to anticipate index changes and the higher this risk. When the index provider belongs to an entity that trades for its own account, manages portfolios, conflicts of interests arise from the possibility of trading ahead of the publication of index changes; such trading could benefit the entity directly when trading for its own account and indirectly by benefiting its portfolio management clients, both at the expense of its index provision clients. If the entity provides other services, e.g. investment advice and research or brokerage services, it could also be tempted to make clients privy to the index changes. Whether the insider information is shared with clients or not, its use constitutes insider trading that is illegal in most jurisdictions.

The same conflicts of interests may motivate manipulation of the index methodology (at the design, implementation or update stages) in a direction that could benefit the perpetrator directly or indirectly. Such conduct, which as we previously observed may not currently fall under specific regulation given the unregulated nature of index provision as a financial activity, will be facilitated when index methodology is non-systematic and is allowed to remain opaque.

In such cases, the integrity of the index would be compromised with a view to benefiting the entity either directly e.g. when it holds a position that will be positively affected by the index change, or indirectly e.g. when it benefits a client of the entity.

One particular instance involves conflict of interests between index provision and origination and listing activities whereby the latter are facilitated or made more profitable by the perspective of the issuer's securities inclusion into the index; index users are affected to the extent that index integrity is compromised and their exposure is altered in a direction that may not be the most appropriate to achieve the index's goal. Such conflicts of interests are present in groups that combine index provision with investment banking activities as well as in groups that combine index provision with listing and trading activities.

On 24 May 2011, Swiss incorporated Glencore was listed on the London Stock Exchange and immediately included into the FTSE 100 benchmark index. As underlined in the exchange's press release, this was London's largest ever international IPO and that the company was the first to enter FTSE 100 at admission in 25 years.²¹²² At the time of listing, the company's free float was 12% (Woods, 2012), however following an opportune October 2010 change to the Ground Rules, shares locked up for up to a year post-IPO could be counted towards the minimum free float limit of 50% (Linklaters, 2010); Glencore met the free float requirement once locked-up shares were taken into account.

Another temptation for index providers is to use the leeway introduced by non-systematic index methodologies to alter index composition in directions which they may consider to be in the best commercial interests of the index but which may not be in the interests of index users.

The September 2012 inclusion of Belgian chemical company Solvay into the NYSE Euronext index of blue chip companies traded in Paris—while the company was incorporated in Belgium, had a primary listing in Brussels, and was already a constituent of the NYSE Euronext index of blue chip companies traded in Brussels—was publicly justified by the company's important footprint in France but was interpreted as reflecting the index provider's willingness to increase the sector diversification of the index (retention of ailing technology company Alcatel-Lucent was interpreted similarly by the media e.g. de Laborde-Noguez (2012)). The economic footprint criterion is in no way applied systematically – doing so would in fact challenge the presence of current index constituents whose main production base or main market is not France. Such inconsistency in the use of criteria was possible as the Ground Rules for the Paris NYSE Euronext blue chip index had given the Index Scientific Committee complete discretion to choose amongst a host of criteria when making inclusion/exclusion decisions. The fact that a stock ended up being a constituent of two benchmark indices prepared by the same provider with a view to represent different markets leaves little doubt on the systematic nature and internal consistency of the methodologies used by this provider at the time.²³

²¹ In the words of the exchange's CEO: "As one of the largest IPOs in history, we are delighted Glencore has chosen the London Stock Exchange. ***Its London listing will give it*** exposure to the world's deepest pool of international capital; ***entry to one of the world's most tracked and traded indices, the FTSE 100***, and access to a global community of financial and markets expertise. The size and success of Glencore's flotation shows ***London is very much open for business***, and that its investor base has the appetite and capability to support large fundraisings. Our pipeline is strong, and we look forward to welcoming further companies to our markets in the months ahead."

²² As stated in the press release: "Under the FTSE fast entry rule if, ***in the view of the FTSE Europe/Middle East/Africa Regional Committee***, a new issue's full market capitalisation amounts to 1.0% or more of the full capitalisation of the FTSE All-Share, ***before the application of individual constituent investability weightings***, then the committee will normally decide to include the new issue as a constituent of the FTSE 100 after the close of business on the first day of official trading." The emphasis is ours – as Woods (2012) explains Glencore entered the UK Index Series at an investability weight of 12%.

²³ It is common to see companies that are incorporated in one country, headquartered in another country, and listed in one or several third countries. Therefore discrepancies in country allocation are to be expected across providers using different methodologies. While some index providers have systematic rules on nationality classification e.g. Russell indices, others give committees discretion on the matter as illustrated here.

Whatever the stated corporate governance principles and the rules for the prevention of conflicts of interests, the existence and nature of a link between an index provider and an entity that will directly or indirectly benefit from the index provider's decisions are a cause for concern.

Conflicts of interests in relation to performance

The high margin licensing model that has grown rapidly to represent a significant share of the revenues of index providers creates conflicts of interests because fees charged by the licensor are typically based on the amount of assets tracking the index at the licensee. While not absent in market indices, these are a particular concern with strategy indices.

Market indices being primarily marketed on the basis of representativeness, index providers are relatively independent with respect to the performance of their market indices: a market index makes no promise to beat the market, merely to represent it and users are unlikely to question the quality of the index if it has recorded disappointing performance. Strategy indices, on the contrary, are primarily marketed on the basis of their performance, including their over-performance relative to market indices. While competition amongst providers of market indices may create incentives to show the best historical performance possible, attractive track records are central selling points in the marketing of strategy indices.

Performance-based competition and indexation of provider revenues to the assets under management could tempt designers to use the leeway provided by the ground rules to try and select or weight components with a view to improving the performance of their indices – this temptation is of course magnified when there is perfect hindsight about the subsequent performance of components i.e., when these decisions are made to simulate an historical track record (Amenc and Ducoulombier, 2012b).²⁴

When track records are materially based on back-tested data—which is notably the case with strategy indices that are a type of financial innovation that typically brings added-value to investors—there are risks that the index methodology may have been optimised on the basis of this data (in sample) with little or no regard for the stability or persistence of its performance beyond this period (out of sample). There are also risks that hindsight biases (choosing from survivors, using restated/backfilled data, picking winners or shunning losers, etc.) entered the simulation whether or not there was an intention to mislead. Realistic simulation of a track record is time consuming and requires the use of point-in-time data as well as simulation of index committee decisions that attempts to control for hindsight biases whenever discretion is exercised.

The above is true whether the index methodology is systematic or not. If the methodology is systematic, its application outside of the back-tested period may yield very different results and its actual risk-return profile may bear little resemblance with that displayed during the back-tested period if no concern for out-of-sample stability was shown in design, if back-tested data was contaminated by hindsight, or implementation of the methodology is not consistent across periods. If the methodology is not systematic, little consistency or stability should be expected in the first place.

²⁴ In the previous French equity benchmark example, incoming stock Solvay had recorded strong year to date performance while the outgoing stock had a dismal year and was heavily shorted – naturally such opposite fortunes are to be expected at the index inclusion threshold and tactical considerations based on recent performance are rational only if stocks exhibit momentum; more importantly, they are legitimate only if allowed by the index methodology. Ranaldo and Häberle (2005) remark that methodologies for indices that are not all-inclusive “are conformable to momentum strategies.” In other words, no discretion is required to embed momentum in commonly used market indices. Besides, academic studies have documented that inclusions in (exclusions from) benchmark indices led to short-term over-(under-) performance.

Conflicts of interests in self-indexing

Against the backdrop of the above, the idea of self-indexing, whereby investment managers track indices that they have designed and are managing, may come across as a recipe for conflicts of interests and the perfect setting for abuse.

Entities pursuing self-indexing justify the move by cost and quality-control concerns. Cutting out independent index providers that charge sizable licensing fees in relation to assets under management would indeed result in significant savings for the largest investment managers in the indexing space.²⁵

The United States Securities and Exchange Commission has authorised a number of investment managers to self-index when it was satisfied that adequate arrangements existed to maintain compliance with restrictions on investment managers' transactions with affiliated parties. This included provisions to minimise the risk of abuse such as outsourcing of the index calculation role or physical separation between index provision and investment management (Amery, 2012).

While the UCITS directives do not prohibit self-indexing, the recent ESMA guidelines have stated that an index that has been “created and calculated on the request of one, or a very limited number of, market participants and according to the specifications of those market participants” could not be considered an adequate benchmark²⁶ and therefore would be ineligible as an underlying (ESMA, 2012). At face value, this would considerably reduce the scope for self-indexing and could in general be very detrimental to the further development of strategy indices.

With respect to conflicts of interest, we challenge the relevance of the traditional distinction between self-indexing and the reliance on an index provided by a third-party e.g. a self-styled independent index provider. We consider that this distinction is likely to mislead investors into believing that the latter entails a materially lower risk of manipulation with respect to index performance (or choice of constituents). Since the licensing-fee model adopted by index providers aligns their interests with those of the investment managers tracking their indices, conflicts of interests arising within these providers are comparable to those faced by self-indexers. Condoning this false distinction could reduce the incentives for investors to perform effective due diligences on the actual risks of indices offered by providers and exacerbate adverse selection and moral hazard phenomena. From an investor welfare point of view, there may also be serious costs involved with limiting competition and innovation in the area of index provision.

Likewise, we consider that the use of the expression “independent index provider”, which has been used by providers that wish to draw a line between them and self-indexers should be either be banned outright or reserved to index providers whose ownership and control structures and

²⁵ In October 2012, index fund pioneer Vanguard announced that it would be switching benchmarks for half a trillion dollars that had until then been tracking MSCI indices to indices provided by FTSE and the University of Chicago Booth School of Business' Center for Research in Security Prices (CRSP). In its press-release, Vanguard (2012) contended that licensing fees have represented a growing portion of the expenses that investors pay to own index funds and ETFs and explained it had negotiated licensing agreements that would produce value for investors and lower expense ratios. In August 2011, BlackRock, whose iShares subsidiary is the leading provider of exchange-traded funds (ETFs), petitioned the United States Securities and Exchange Commission for permission to self-index its iShares ETFs; the decision is still pending.

²⁶ The concept of adequate benchmark is introduced in the UCITS space by the Eligible Assets Directive (EC, 2007). The article clarifying the definition of financial indices (Article 9) states that they need to be sufficiently diversified, represent an adequate benchmark for the market to which they refer, and must be published in an appropriate manner (the latter includes sound procedures to collect and process data and subsequently publish the index value, including pricing procedures for components where a market price is not available; wide and timely provision of material information on matters such as index calculation and rebalancing methodologies and index changes.) For an index to be an appropriate benchmark, it must (i) measure the performance of a representative group of underlyings in a relevant and appropriate way; (ii) be revised or rebalanced periodically to ensure that it continues to reflect the markets to which it refers following criteria which are publicly available; and (iii) have underlyings that are sufficiently liquid to allow users to replicate the index, if necessary.

other business operations do not create obvious internal or external conflicts of interest. All providers, whether independent or not, should identify, disclose and manage conflicts of interest

Question 10: *Do you agree that the Administrator's oversight committee or other body could provide independent scrutiny of all relevant activities and management of conflicts of interest? Please comment if and why any different approaches might be appropriate for different kinds of Benchmarks. For example, where Administrators simultaneously act as the trade body for Submitters to the Benchmark. What is the minimum level of independent representation this committee or body should include?*

While governance mechanisms such as oversight committees may play a role in the mitigation of conflicts of interests, we consider these to be a third order priority. The provision of full and complimentary transparency of Methodology and historical Benchmark data is the most powerful mitigator of conflicts of interest; second to it is the existence of a strong control framework.

We strongly caution against any temptation to trade lower levels of transparency (and/or a laxer control framework) against stronger governance mechanisms. Whatever the governance mechanisms in place, we consider that transparency that merely allows (would be) users to “understand how the Benchmark is derived and its potential limitations” is insufficient and that the correct level of transparency is one that allows for independent replication of the index by (would be) users for *any* published Benchmark level.

We observe that governance mechanisms such as oversight committees have too often proven ineffective at ensuring good behaviour or protecting the interests they are expected to defend, even when these mechanisms impose a strong fiduciary duty on their participants. We thus consider that such governance mechanisms can at best support transparency and control frameworks and at worst exacerbate moral hazard and adverse selection phenomena.

Oversight committees, including independent committees, may not be exempt of conflicts of interests themselves and are susceptible to capture by management or other powerful interests.²⁷ For illustration, see the report on the Permanent Subcommittee on Investigations about the role of the board of directors in the collapse of Enron (United States Senate, 2002). For a conceptual approach, read Macey (2010) on the inherent faults of nonmarket corporate governance devices such as boards and whistle-blowers, the superiority of market-driven mechanisms and the risk of inefficient regulations encouraging the former and hampering the latter.

Corporate governance mechanisms have proven incapable of averting major scandals in the past and the reforms of these mechanisms triggered by these very scandals should not be expected to radically improve their effectiveness. As Macey (2010) remarks: “Indeed, one of the great ironies of the myriad new corporate governance rules passed by courts, legislatures, administrative agencies, and stock exchanges in response to the collapse of Enron is that Enron itself met or exceeded the higher standards ostensibly promulgated to prevent future “Enrons.” Oddly, if Enron survived to this day, it would not have to change its corporate governance structure at all at to conform to the requirements of the Sarbanes-Oxley Act.” Deakin and Konzelmann (2004) argue that the role of the board of directors in the Enron collapse has been misunderstood as the board’s inability to “effectively monitor what (...) managers were doing, with conflicts of interest

²⁷ This is not to say that best practices is a meaningless expression. We recognise that some Benchmark Administrators impose strict rules to prevent and manage conflicts of interests within the committees they establish while other administrators fail to do so.

identified as the root cause of this failure” and instead explain that the board failed by “underestimating the risks that were inherent in the company’s business plan and failing to implement an effective system of internal control.” Deakin and Konzelmann attribute the board’s failure to the “complexity of the monitoring task” and consider that reforms bolstering the independence of directors are “likely to be of limited value and perhaps even counter-productive.”

We thus consider that governance mechanisms such as oversight committees can at best support transparency and control frameworks and at worst exacerbate moral hazard and adverse selection phenomena.

D. Accountability

Question 14: *Are the measures discussed in the Consultation Report (e.g., complaints process, Audit Trail, external audits and requirement for regulatory cooperation) sufficient to ensure the accountability of the Administrator? Should additional mechanisms be considered?*

With respect to documentation requirements, we have previously underlined the need for full transparency of Methodology and historical Benchmark data to allow for independent replication of the published Benchmark track record and for disclosure and explanation of instances of discretion. This presupposes the existence of an audit trail and the availability of documentation not only to “the relevant regulatory authorities on request” but also to (would be) index users on an ongoing basis (at least up to the minimum level required for independent Benchmark replication).

We are not opposed to periodic external verification of the integrity of Benchmark processes but again wish to underline that the priority should be to provide sufficient transparency to (would be) index users and other parties so as to enable the performance of advanced due diligences on the systematic character of the Benchmark Methodology and the risks and performance characteristics of the Benchmark. Such due diligences not only allow to gauge the intrinsic quality of a Benchmark and its susceptibility to discretionary decisions, but also enable each (would be) user to assess the suitability of the Benchmark in the context of its specific goals. While the certification of Benchmark integrity can be done centrally by an independent third party, Benchmark suitability must be assessed by each (would be) user.

We remark that while ESMA has required UCITS to carry out “appropriate documented due diligence on the quality of the index” which includes assessing whether “there is an independent audit and the scope of such an audit,” it has also prohibited investment in indices “for which the full calculation methodology to, inter alia, enable investors to replicate the financial index is not disclosed by the index provider” or “whose methodology for the selection and the re-balancing of the components is not based on a set of pre-determined rules and objective criteria” or indices “that do not publish their constituents together with their respective weightings.” (Ducoulombier 2012 and ESMA 2012). We regard ESMA’s orientations as very positive for the healthy development of the Benchmark provision business.

Question 16: *Is public self-certification of compliance with industry standards or an industry code another useful measure to support accountability? This approach might also contemplate explanation of why compliance may not have occurred. If so, what self-certification requirements would make this approach most reliable and useful to support market integrity?*

As with governance mechanisms, we consider that self-certification of compliance with industry standards and industry codes are at best of third order importance and at worst counterproductive due to moral hazard and adverse selection phenomena. They should thus be used as support of, rather than alternatives to, full transparency and strong control frameworks.

Codes of ethics and standards of professional conduct promulgated by professional associations have been insufficient to instil strong ethical cultures within financial companies²⁸ or prevent the recent crisis and associated loss of trust by the public.²⁹

Chapter 3 Discussion of options for enhanced oversight of Benchmark activities

Question 20: *What are the advantages and disadvantages of making Benchmark Administration a regulated activity?*

Making Benchmark Administration a regulated activity, if synonymous with high compliance costs or capital charges, would impose significant costs in terms of competition and innovation by creating significant barriers to entry into, and forcing consolidation of, an industry which historically has been very concentrated. Whereas the last few years have seen the birth of products and initiatives that have challenged traditional indices and traditional index providers, this could turn back the clock on technical and business model innovation and lead to an oligopoly of the kind existing in the credit rating industry, with adverse consequences for the quality, diversity and cost efficiency of the products that are at the heart of the passive investment management industry.

Furthermore, making Benchmark Administration a regulated activity would likely create a false sense of trust among investors. Once Benchmark Administration becomes a regulated industry, investors may no longer regard Benchmarks as private information that should be questioned and may be tempted to reduce their due diligence efforts, which could in aggregate increase risks within the industry.

²⁸ In its most recent Global Market Sentiment Survey, CFA Institute members identified the lack of ethical culture within financial firms as the factor that contributed the most to the current lack of trust in the financial industry (56% of responses), well ahead of market disruptions (16%) and poor government regulation and enforcement (16%). The professionals surveyed identified the most-needed action as the establishment and encouragement of an improved ethical culture by top management and executives (CFA, 2012). CFA Institute is the largest professional association of investment professionals in the world and its more than 100,000 charter holders and 100,000 programme candidates are required to abide by “the highest ethical standards” as presented in the CFA Institute Code of Ethics and Standards of Professional Conduct. The Chartered Alternative Investment Analyst Association (CAIA Association) has adopted the CFA Institute Code and Standards for its charter holders and programme candidates.

²⁹ This should not be misconstrued as an indictment of the financial services industry as morally bankrupt or of financial professionals as particularly corrupt. Scandals in the food and healthcare industries are common, as are substantiated accusations of industry capture of regulatory authorities. The protections provided by the Hippocratic Oath, probably the oldest professional code of ethics in the history of humanity or the codes of conduct published by colleges of physicians worldwide seem to be patchy. Our point is not to point the finger at an industry or category of professionals but to underline the inherent limits of codes and standards.

Question 22: *What distinctions, if any, should be made with regard to Benchmarks created by third parties and those created by regulated exchanges?*

See our answer to Consultation Question #9. By nature, Benchmark Administrators linked to exchanges should not be allowed to use the term “independent” when referring to their Benchmark Administration activities. As others index providers facing conflicts of interest, they should identify, disclose and manage these conflicts.

Question 25: *Do you believe that a code of conduct, either on its own or in conjunction with other measures outlined within the report, would provide sufficient oversight to mitigate the risks that have been identified in Chapter 2? What measures should be established in conjunction with a code of conduct? For which Benchmarks is this approach suitable?*

Question 26: *What other measures outlined in the report, if any, should apply in addition to a code of conduct? If you believe a code of conduct, either on its own or in conjunction with other measures outlined within the report, would provide sufficient oversight to mitigate the risks that have been identified in Chapter 2, what type of code of conduct should apply (e.g., a voluntary code of conduct, an industry code of conduct submitted to and approved by the relevant Regulatory Authority, a code of conduct developed by IOSCO, etc.)?*

See our answer to Consultation Question #16.

Question 27: *Do you believe that the creation of a Self-Regulatory Organisation (e.g., one that exercises delegated governmental powers) and itself subject to governmental oversight, whether or not in conjunction with industry codes, is a viable alternative for sufficient oversight and enforcement to mitigate the risks that have been identified in Chapter 2? For which Benchmarks is this approach suitable? What if any complementary arrangements might be necessary, such as new statutory obligations or offences for Administrators and/or Submitters?*

It is not immediately clear what the use of a Self-Regulatory Organisation would bring over direct regulation. With respect to the relevance of making Benchmark Administration a regulated activity, see our answer to Consultation Question #20. Here again, we reiterate that the most powerful tool to mitigate the risks identified in Chapter 2 is full transparency.

The academic literature on Self-Regulatory Organisations underlines the difficulty of designing effective systems. For example, King and Lennox (2000) conclude that sanctions are required for such systems to be functional. Lennox (2007) concurs: “absent explicit mechanisms for penalizing malfeasance, self-regulatory programs are likely subject to adverse selection and moral hazard. (...) however, self-regulatory programs are limited in the punishments they may administer.” Likewise, Green and Hrab (2003) observe: “Self-regulation requires a check on self-interested action by the self-regulating industry. Increasing accountability by self-regulating industries to the public and government in the setting and enforcing of public goals raises administrative costs (potentially above the costs of direct government regulation). It can also reduce the “efficiency” and effectiveness of regulatory instruments. However, without these accountability mechanisms in some form, self-regulation is an invitation to self-interested rule-making by the “regulated” parties.”

Question 29: *Do you believe that users of a Benchmark, specifically the users who are regulated or under the supervision of a national competent authority, should have a role in enhancing the quality of Benchmarks? Which form should this role take: on a voluntary basis (e.g., the user being issued a statement that will only use Benchmarks that follow IOSCO principles), or on a compulsory basis (e.g., the competent authority could request that users who are registered under their jurisdiction should only use Benchmarks that fulfil IOSCO principles)?*

We strongly believe that the professional users of Benchmarks which are regulated or under the supervision of a national or international competent authority should have a role in enhancing the quality of Benchmarks. This could be on a voluntary basis when these professionals act for their own account or for the account of other professional users and should be on a compulsory basis when they act on behalf of non-professionals. We consider that the approach taken by ESMA with respect to the use of financial indices by European harmonised retail investment funds is exemplary and will exert a powerful positive influence on the index provision industry.

As previously mentioned, ESMA has recently required from UCITS that they ensure that (would be) investors have free and easy access to the full Methodology, constituents and weights of each index in which the UCITS is invested as well as free access to performance information. It has also barred UCITS from investing in indices whose component selection and weighting methodology is not based upon “pre-determined rules and objective criteria” and demanded that UCITS carry out due diligence on the quality of the financial indices they use (ESMA, 2012). One of ESMA’s key objectives with these new requirements is to restrict UCITS’ choice of indices to those that are built and managed in a systematic manner and for which index providers make available sufficient information to the public to allow for independent replication, which is not only a powerful mitigator of conflicts of interest but also and more importantly a precondition for informed investment decisions.

We would be pleased to discuss further our comments with you and remain at your disposal should you require clarification or additional information.

Yours sincerely,



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