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France's AMF Issues Study on Financial Index Market

[32569]

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Risk Oversight RE: France's AMF Issues Study on Financial Index Market

In June, the French financial regulator, Autorité Des Marchés Finaciers ("AMF"), published a study titled "Opportunities and Risks in the Financial Index Market."[1] Noting the increasingly important role that financial indices are playing in financial markets, the Study examines the regulatory issues and market risks associated with these indices, offers specific policy recommendations, and suggests areas for future research.

Summary of the Study

The Study begins by summarizing the 2018 European Benchmark Regulation ("BMR"), which regulates the provision and use of benchmark indices in Europe.[2] It then provides an overview of the index market, including its participants, growth (in revenues and number of indices), economic structure, services (e.g., data provision, administration, dissemination of information, and design), and trends (e.g., towards increasing variety and methodological complexity of offerings). It recounts the ways in which various market participants use indices, including passive funds (which attempt to replicate the performance of "investable" indices) and actively-managed funds (which use indices as an external benchmark to measure fund performance).[3] The Study also covers investment trends that have coincided with the growth of the index industry, including growth in passive, factor-based (i.e., "smart beta"), and ESG investing.

The Study then explores issues related to the growth of index-based investing. It identifies the following broad categories of potential index-related risk:

- *The quality of the price formation process*. Surveying academic literature, the Study notes that adding securities to or removing them from an index may affect their prices, and can increase correlations in the prices of an index's underlying securities. It states that it "remains to be seen whether these inefficiencies constitute market failures resulting, for example, from the cost or lack of market information (data, ratings, financial analysis, etc.) or from obstacles to arbitrage."

- *Financial stability*. The Study also surveys academic literature on procyclicality (*e.g.*, index-linked products may create market interconnections that could promote the propagation of shocks), and effects on liquidity transformation (e.g., the search for yield and liquidity could lead to increased investments in funds investing in relatively illiquid investments), which demand for index-linked investments could exacerbate. Impacts of "technical" effects (e.g., linked to the rebalancing of indices or methodological changes, which present potential conflicts of interest for index providers) and operational risks (*e.g.*, from errors or discontinuity in calculations) are also highlighted.

- *The competitive operation of the market*. The Study suggests that oligopolistic competition and the increasing consolidation of the sector not only limit product transparency but also the ability to compare prices.

- *Investor protection*. Concerns relate to the: (i) lack of transparency and the limited ability to identify and compare indices; (ii) difficulties in understanding certain complex or proprietary indices, particularly when the boundary between index and asset management becomes blurred and indices incorporate multiple management rules and/or discretion; (iii) cost to investors of the predictability of index trading needs (e.g., increased transaction costs that may be caused by front running index rebalancing).

The Study presents these risks, along with related guidance or recommendations, in tabular format.[4] Recommendations include or relate to:

- Analysis and risk management to maintain efficiency and stability in secondary markets;[5]

- Greater transparency for investors;[6]

- Management of technical and operational risks of index administration;[7] and

- Fostering competition.[8]

The Study concludes by calling for further research on:

- The risks to investor protection associated with the use of indices;[9]

- The effects of the growth of index-linked management on the governance of listed companies;[10]

- The issues related to lending reference rates and ongoing reforms;

- The impact of indices on the formation of market equilibria, financial stability, investor protection, market integrity, and operational resilience; and

- The use of proprietary indices (self-indexation) by market intermediaries.

Matthew Thornton
Assistant General Counsel

Nicolas Valderrama
Legal Intern

endnotes

[1] *Opportunities and Risks in the Financial Index Market*, Autorité, Des Marchés Finaciers, Laurent Grillet-Aubert (June 2020) (the "Study"), *available at* https://www.amf-france.org/sites/default/files/2020-06/opportunities-and-risks-in-the-financial-index-markets.pdf.

[2] "Index" is defined as "any figure: (a) that is published or made available to the public; (b) that is regularly determined: (i) entirely or partially by the application of a formula or any other method of calculation, or by an assessment; and (ii) on the basis of the value of one or more underlying assets or prices, including estimated prices, actual or estimated interest rates, quotes and committed quotes, or other values or surveys."

[3] The Study also mentions that indices are used as: (i) a reference for futures or derivatives contracts; (ii) a reference for loan agreements (indexed rates); and (iii) an informational (public-good) benchmark, as an indicator of the cyclical economic performance of a market or sector.

[4] Study at 55.

[5] These include: (i) reviewing potentially excessive risk-taking in bonds and derivative markets, where such index-linked products might see more illiquidity issues and systemic risk; (ii) considering informing the public about certain exposures and/or risk transfers, particularly in derivatives markets; and (iii) managing extreme risks (*i.e.*, liquidity risks) and examining the appropriateness of circuit breakers (especially in correlated markets).

[6] These include making it easier to identify and compare indices by: (i) identifying and reporting financial indices, similar to how third-country indices are listed on ESMA's website; (ii) harmonizing the index categories currently in use and, where appropriate, the index-linked product categories; and (iii) systematically allocating index identification codes and identifying index-linked products (through a Unique Product Identifier).

[7] The Study notes that in Europe, the BMR provides a supervisory framework focused primarily on governance, and recommends consideration of reporting of errors or interruptions in calculating indices.

[8] This includes: (i) encouraging the systematic identification of index administrators; (ii) promoting price transparency (especially regarding the structure and sources of fees and the provision of services related to index usage); and (iii) clarifying the scope of index administration within consolidated financial services groups to facilitate comparisons with "pure players" (*i.e.*, entities that exclusively administer and promote indices and are not part of diversified financial groups)).

[9] The Study suggests that this is particularly challenging when indices' transparency and comprehensibility rely on: (i) proprietary data and/or non-financial information that may be

difficult to access, costly, and/or involve complex data valuation issues; and (ii) explaining how the index calculation rules incorporate complex and/or discretionary information that tends to characterize portfolio management strategies.

[10] The Study mentions the “common ownership theory,” advanced by some in the academic community, that asserts that institutional investors’ holdings of competing firms in concentrated industries reduces competition. It also cites literature to the contrary and characterizes the literature overall as “somewhat inconclusive regarding the impacts of passive management and ETFs on the governance of listed companies.”
