INVESTMENT COMPANY INSTITUTE

**COMMENT LETTER**

February 11, 2013

# ICI and ICI Global Submit Comments to IOSCO on Financial Benchmarks (pdf)

February 11, 2013 Mr. Alp Eroglu International Organization of Securities Commissions (IOSCO) Calle Oquendo 12 28006 Madrid Spain Re: Consultation Report CR01/03 on Financial Benchmarks Dear Mr. Eroglu: The Investment Company Institute1 and ICI Global2 appreciate the opportunity to comment on IOSCO's Consultation Report on Financial Benchmarks (the "Consultation").3 ICI and ICI Global members collectively manage over $15 trillion in regulated investment funds such as mutual funds, closed-end funds, and exchange-traded funds ("ETFs"). Many invest and trade in financial contracts referenced to benchmarks such as LIBOR and EURIBOR, and some also manage funds that are designed to track the performance of indices more generally. From both of these perspectives, ICI and ICI Global members have a strong interest in IOSCO's recommendations on benchmarks. For reasons explained below, we strongly believe that one size does not fit all when it comes to the regulation of benchmarks, and that IOSCO can and should draw distinctions between survey-based benchmarks, such as LIBOR, and other types of benchmarks, such as commercial indices licensed by regulated funds.4 The Consultation identifies a number of serious concerns with respect to survey- 1 The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $14.2 trillion and serve over 90 million shareholders. 2 ICI Global is the global association of regulated funds publicly offered to investors in leading jurisdictions worldwide. ICI Global seeks to advance the common interests and promote public understanding of global investment funds, their managers, and investors. Members of ICI Global manage total assets in excess of US $1 trillion. 3 The Board of the International Organization of Securities Commissions, Consultation Report CR01/03 on Financial Benchmarks, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD399.pdf. 4 In this letter, we use the term "survey-based benchmark" to refer to benchmarks, such as LIBOR, that are determined based on surveys or other subjective submissions. We use the term "commercial index" to refer to commercially provided indices that are licensed for a fee, such as the S&P 500 or FTSE 100. Unlike survey-based benchmarks, the data for commercial Mr. Alp Eroglu February 11, 2013 Page 2 of 8 based benchmarks, and IOSCO is to be commended for seeking to address them. To the extent IOSCO wishes to expand its review to other categories of benchmarks that have not exhibited the same types of failures (e.g., commercial indices), it should begin by identifying specific, tangible concerns that warrant regulatory intervention. Only then should it seek to develop regulatory recommendations, and such regulations should be specifically designed to address those concerns. Our comments on the Consultation follow. In general, we focus on the Consultation as it could be interpreted to relate to commercial indices used to measure the performance of a security, and specifically, a security issued by a regulated "index" or "tracker" fund.5 Chapter 1 – Scope of the Consultation The Consultation clearly has roots in recent events that have eroded confidence in the credibility of LIBOR and similar survey-based benchmarks. Its scope, however, is far broader, as it defines "benchmark" to include rates, indices and figures that are used not only for determining amounts due under financial contracts, but also for measuring the performance of a financial instrument. Exhibit 1 of the Consultation makes it clear that IOSCO contemplates recommendations that would apply not only to benchmarks such as LIBOR, but also to exchange-traded products that track indices, such as ETFs.6 The very first question in the Consultation is whether we agree with this scope. As suggested above, we see it as overly broad. Commercial indices do not share the characteristics that underlie the erosion of confidence in LIBOR, namely, a survey-based methodology that is susceptible to manipulation. As a result, any attempt to develop of a single set of regulatory principles to address the entire diverse universe of benchmarks and commercial indices would be ill advised, in our view. ICI and ICI Global have supported efforts to reform the process for establishing LIBOR and other survey-based benchmarks.7 In particular, we support measures that could strengthen the indexes is typically taken from a regulated exchange or other source of market bids, offers, or executed prices, and is not based on voluntary submissions. 5 We use the term "regulated fund" to refer to funds and ETFs that are registered in the United States under the Investment Company Act of 1940, in Europe pursuant to the Undertakings for Collective Investment in Transferrable Securities ("UCITS"), or elsewhere in the world under similar regulatory regimes. Funds that are designed to closely track the performance of a benchmark are commonly referred to as "index" or "tracker" funds. 6 See Consultation at pages 9 (for Exhibit 1) and 48 (for the definition of "benchmark"). 7 See letter from Paul Stevens, President and CEO, Investment Company Institute, and Dan Waters, Managing Director, ICI Global, to The Wheatley Review, dated September 7, 2012, available at http://www.ici.org/pdf/26495.pdf (the "ICI/ICI Global Wheatley Review Letter"). We also commented on the European Commission's recent consultation. See letter from Paul Stevens, President and CEO, Investment Company Institute, and Dan Waters, Managing Director, ICI Global, to the European Commission, dated November 29, 2012, available at http://www.ici.org/pdf/26738.pdf (the "ICI/ICI Global EC Letter").  credibility of those benchmarks, make the rate-setting process more fact-based and transparent by using transaction data to the greatest extent possible, and improve governance over rate submissions and calculations. We support IOSCO's efforts toward these ends.8 Commercial indices, on the other hand, are subject to existing regulation and market forces that provide a number checks and balances that mitigate the concerns expressed over LIBOR and other survey-based benchmarks. We therefore urge IOSCO to evaluate benchmarks and commercial indices separately. Should IOSCO identify any concerns specific to commercial indices, it should then examine whether regulatory or market-based solutions already exist to address those concerns. Only if IOSCO finds that its concerns are not adequately addressed should it consider regulatory recommendations. Chapter 2A – Benchmark Methodology Question 2 in the Consultation asks whether we agree that the design of a benchmark should clearly reflect the key characteristics of the underlying interest it seeks to measure. This seems like a rhetorical question—as a principle, of course it should. The more nuanced question IOSCO should have asked, however, is to what extent additional regulation is necessary to enforce this principle. In the case of commercial indices, we do not believe additional regulations are necessary to ensure their utility or credibility. That is not to say that regulations have no role to play; a regulated fund that licenses and tracks a commercial index is subject to a variety of requirements designed to ensure that the index is suitable for that purpose and that fund investors have the information necessary to evaluate the fund and index.9 A more powerful check on the credibility of a commercial index, however, is that the licensees are sophisticated investors that will only pay for a high quality product— i.e., an index that reflects the key characteristics of its target market. Unless they are satisfied, the index will not gain traction in the marketplace. Chapter 2A of the Consultation discusses at length specific concerns over the quality and vulnerability of data inputs, administrator discretion, the composition of submitting panels, calculation options, and the like. Many of these concerns, while valid with respect to survey-based benchmarks such as LIBOR, are simply not relevant to the production of commercial indices used by asset managers, for a number of reasons: 8 We have been—and remain—skeptical about the ability of regulators to encourage or facilitate the migration to an alternative benchmark, as discussed in Chapter 4B of the Consultation and questions 35-41. Ultimately, the economic terms in any contract are a matter of choice for the parties to that contract. 9 For example, the UCITS Directive imposes requirements with respect to an index's diversification, adequacy as a benchmark for the market to which it refers, and transparency. Similarly, the Code of Unit Trusts and Mutual Funds, published by the Hong Kong Securities and Futures Commission, requires indices to, among other things, have clearly defined objectives and be objectively calculated and rules-based. Mr. Alp Eroglu February 11, 2013 Page 4 of 8 • The data is more robust. The underlying data for securities indices is typically taken from a regulated exchange or other source of market bids, offers, or executed prices. This is in stark contrast to survey-based benchmarks such as LIBOR, which require subjective estimates of the price of theoretical transactions.10 • Administrators have less discretion. There is far less administrator discretion with respect to a commercial securities index, and what minor discretion the administrator has presents little opportunity for manipulation.11 • Interested parties have no meaningful opportunity to influence. Asset managers and others may be invited to participate on advisory committees organized by the index providers to share market insight, but such committees are advisory in nature and have broad participation, such that attempts at manipulation would be neither effective nor unnoticed. Moreover, the asset managers are not submitters of the data underlying the indices. • Administrators have every incentive to prevent manipulation. Most importantly, index providers have a strong commercial incentive to provide high quality indices for asset managers. Any commercial index provider that allowed—or was even perceived to allow—manipulation of its benchmarks would stand to lose far more than it could gain from any potential manipulation. These characteristics of commercial indices used by asset managers provide effective checks against the concerns detailed in Chapter 2A. Chapter 2B – Benchmark Transparency Question 5 of the Consultation asks 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 ongoing basis. While this is an important question, again we encourage IOSCO to focus not just on transparency, but also on the appropriate role of regulation in achieving that transparency. 10 In our letter to the Wheatley Review, we expressed support for the concept of using available transaction data on bank borrowings to corroborate LIBOR, and recommended further exploration of whether LIBOR rates should be maintained for maturities and currencies for which insufficient transaction data is available. See the ICI/ICI Global Wheatley Review Letter, supra note 4, at 3-4. 11 For example, administrators might have discretion with regard to the precise parameters for the categorization of countries (e.g., which countries should be considered "frontier," "emerging," or "developed" markets) or appropriate capitalization ranges (e.g., how to distinguish "large cap," "mid cap," and "small cap" securities), but these decisions are made in accordance with the administrator's disclosed methodologies. 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February 11, 2013 Page 5 of 8 In this regard, we do not believe additional regulation is necessary to ensure sufficient transparency with respect to commercial securities indices. Administrators that license their indices to asset managers provide a great deal of information about their methodology and selection criteria—far more information than is available about the methodology of LIBOR—and asset managers carefully monitor the index formulation and constituents to ensure that the criteria are being followed. This information certainly allows the licensing asset manager to assess the credibility, representativeness, relevance, and suitability of a benchmark on an ongoing basis—that is, to paraphrase the Consultation, "to understand how a Benchmark is derived …, what it measures and therefore understand the suitability of the Benchmark for their purposes and any limitations or risks of the Methodology."12 Asset managers demand this information as part of their due diligence in selecting and monitoring their investment portfolios. The Consultation's suggestion that the same level of transparency be made public is unnecessary and, moreover, would have significant negative consequences. First, requiring benchmark administrators to publicly disclose methodologies in such detail that any user—not just a licensee— could replicate their index harms fund investors by facilitating "free riding" (in which investors outside an index fund can replicate the strategy, while investors in the fund pay for the development of the strategy) and "front running" (in which investors outside of a fund are able to place trades ahead of the fund).13 Requiring such public disclosure also risks severe damage to the value of the administrators' intellectual property and index licenses.14 And finally, as discussed in more detail below, imposing such costs on index providers could harm investors by reducing competition and stifling the development of new and innovative market indices. These costs and negative consequences are not justified by any potential benefits, as this level of public disclosure is unnecessary to address IOSCO's stated intent of enabling users to assess the credibility, representativeness, relevance, and suitability of a benchmark on an ongoing basis. Chapter 2C – Benchmark Governance Chapter 2C of the Consultation sets forth concerns over potential conflicts of interest that may arise in the benchmark setting process. We agree that conflicts may arise, but again urge IOSCO to 12 Consultation at page 19. 13 See, e.g., Exchange-Traded Funds, Proposed Rule, SEC Release Nos. 33-8901 and IC-28193 (March 11, 2008), 73 Fed. Reg. 14618 (March 18, 2008), available at http://www.sec.gov/rules/proposed/2008/33-8901.pdf at page 26 and note 42 (discussing the potential detrimental impact of real-time portfolio disclosure on fund investors). 14 See, e.g., letter from MSCI in Response to the European Commission Consultation on the Regulation of Indices, available at http://ec.europa.eu/internal_market/consultations/2012/benchmarks/individual-others/msci_en.pdf (stating that "equity indices constitute intellectual property which is protected by national and international laws and conventions," and warning the EC that "regulation that requires index providers to make their intellectual property (for which they normally charge a fee to access) freely available without restriction, allowing others to free-ride, could result in index providers exiting the European market"). Mr. Alp Eroglu February 11, 2013 Page 6 of 8 take care in distinguishing the nature and types of conflicts that may arise with survey-based benchmarks, such as LIBOR, from those that may arise in the context of commercial indices. As discussed above, there is little opportunity or incentive for an asset manager—or anyone else that might have an interest—to manipulate commercial securities indices. As a preliminary matter, the underlying data for securities indices is typically taken from a regulated exchange or other source of market bids, offers, or executed prices, and any index reconstitutions follow a stated methodology and generally are announced in advance of their effective dates. These features leave little opportunity for manipulation. Additionally, unlike benchmarks on which financial contracts are based, these indices do not dictate payments from one party to another, so there would be no direct gain associated from any manipulation. The performance of an index fund—and by extension the fund's manager—is primarily measured by how well it tracks the target index,15 rather than the direction the fund moves; thus, an index fund manager has little incentive to seek to manipulate the index. Moreover, commercial index administrators have every incentive to prevent such manipulation. The index business is extremely competitive; any loss of faith in the integrity of an index would mean commercial ruin to the index provider. At the same time, there is little self-serving benefit to the provider in allowing an index to be manipulated. That is, while an entity that relies on a benchmark to establish a price paid or received for an instrument may benefit from a reduction (if paying) or an increase (if receiving) in the value of the benchmark, the business interests of commercial index providers, as well as those of the asset managers relying on the indices, are best served if the performance of an index accurately reflects the financial value it is intended to measure. Potential conflicts may be greater in the context of funds that track indices administered by an affiliate—a context that fund regulators have carefully considered and addressed. In the United States, for example, the SEC imposes a number of conditions relating to transparency and separation of tasks on "self-indexed" ETFs regulated under the Investment Company Act, which are specifically designed to prevent manipulation of the index to benefit (or harm) the fund.16 These conditions leave little opportunity for a fund manager to manipulate the index. In addition, a framework of federal securities 15 Indeed, index funds that sample their index typically state that a principal risk of the fund is a divergence of the fund's performance from that the index. Some index fund disclosures further explain that because the fund seeks to track an index, the fund will not seek temporary defensive positions when markets decline or seem overvalued. See, e.g., iShares Russell 1000 Growth Index Fund Prospectus, available at http://us.ishares.com/content/stream.jsp?url=/content/en_us/repository/resource/prospectus/is_p_iwf.pdf&mimeType= application/pdf, at S-2. 16 These include requiring the index provider to (i) make publicly available all of the rules governing inclusion and weighting of securities in each index; (ii) limit the ability to change such rules and provide public notice before any changes are made; (iii) impose "firewalls" between the staff responsible for index design and the portfolio management staff; (iv) maintain an unaffiliated "calculation agent" who is responsible for all index maintenance, calculation, dissemination, and reconstitution activities; and (v) specify a limited periodic basis on which the components of the index may be changed. See, e.g., WisdomTree Investments, Investment Company Act Release Nos. 27324 (May 18, 2006) (notice) and 27391 (June 12, 2006) (order). Mr. Alp Eroglu February 11, 2013 Page 7 of 8 laws and exchange rules protect against conflicts of interest and misuse of non-public information.17 Similarly, as ESMA recently noted, specific provisions in the UCITS Directive address conflicts of interest when an index provider is affiliated with an index fund's manager, including transparency requirements, published policies and procedures, and independent valuation.18 Ultimately, while the potential for conflicts of interest clearly is an appropriate area for securities regulators to evaluate, we do not believe that this Consultation identifies a sufficient basis for concern with respect to the potential for conflicts of interest in commercially provided securities indices. Chapter 3B – Drawing Regulatory Distinctions among Benchmarks In Chapter 3 of the Consultation, IOSCO considers a variety of options for enhanced oversight of benchmark activities. It asks whether distinctions in regulatory status warrant different approaches to regulatory oversight (e.g., full regulation in some instances and voluntary codes of conduct in others). In our view, IOSCO ought to draw an initial distinction among benchmarks based upon the documented failures in the governance and controls around survey-based benchmarks, rather than attempting to distinguish benchmarks based on their economic impact (as suggested in Chapter B.1) or the regulated status of any market participant (as suggested in Chapter B.4). To the extent IOSCO wishes to expand its review to other categories of benchmarks that have not exhibited the same types of failures (e.g., commercial indices), it should begin by identifying specific, tangible concerns that warrant regulatory intervention. Only then should it seek to develop regulatory recommendations, and such regulations should be specifically designed to address those concerns. Conclusion—the Costs of Unnecessary Regulation The fact that reforms are needed in the LIBOR context does not, in and of itself, suggest that those same reforms are necessary or appropriate with respect to all securities indices or the firms that sponsor or administer them. The imposition on market indices of unnecessary regulations is not just an issue for index administrators, but also for regulated funds that license the use of their indices and ultimately, their investors. Regulation has the potential to increase costs, which would be passed through to the funds in the form of higher license fees, increasing fund expenses that ultimately are paid by fund investors. Increased regulatory costs also would raise barriers to entry in the index 17 Indeed, the SEC has indicated that the self-indexed ETF conditions are arguably unnecessary in light of these provisions in the federal securities laws and exchange rules. In a 2008 ETF rule proposal, the SEC proposed eliminating the conditions on the basis that these laws and regulations are sufficient. See Exchange-Traded Funds, Proposed Rule, supra note 13. The proposal has not been adopted. 18 See ESMA Report and Consultation Paper, Guidelines on ETFs and other UCITS Issues, supra note 5, at 16-17 (further stating that no further consideration of these conflicts of interest by ESMA is necessary). Mr. Alp Eroglu February 11, 2013 Page 8 of 8 administration business, reducing competition and stifling the development of new and innovative market indices and indexing techniques—to the detriment of index licensees and ultimately fund investors.19 The Consultation identifies a number of important considerations regarding the quality and integrity of a benchmark's methodology, the ability of market participants to understand a benchmark, the potential for conflicts of interest or other weaknesses, and the presence of a governance or oversight structure to identify and mitigate such conflicts or weaknesses. These are legitimate concerns, but we strongly urge IOSCO to resist treating the entire, diverse universe of benchmarks and commercial indices together. It should treat benchmarks and commercial indices separately, identifying in each instance whether potential issues exist and, if so, whether a regulatory approach is necessary. * * * * We sincerely thank you for this opportunity to share our views. If we or our members can be of further assistance as you consider this important matter, please do not hesitate to contact the undersigned. Sincerely, /s/ Karrie McMillan /s/ Dan Waters Karrie McMillan Dan Waters General Counsel Managing Director Investment Company Institute ICI Global 1-202-326-5815 44-203-009-3101 karrie.mcmillan@ici.org dan.waters@ici.org 19 For a more detailed discussion of the potential costs of unnecessary regulation of index providers, see letter from Vanguard in Response to the European Commission Consultation on the Regulation of Indices, available at http://ec.europa.eu/internal_market/consultations/2012/benchmarks/individual-others/vanguard_en.pdf.

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