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IOSCO Survey on interaction between Index Providers and Asset Managers BVI responses to the survey

BVI¹ welcomes the opportunity to present its views on IOSCO survey on the interaction between index providers and asset managers. We will focus our answers on Part A of the survey.

Part A: Questions for Asset Managers:

- **General**

1. Please outline the key jurisdictions / regulatory framework in which your firm operates.
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German investment funds are highly regulated and transparent financial products under the European UCITS/AIFM regimes and have to adhere to the provisions of the EU Benchmark Regulation (BMR). The BMR helps to strengthen the confidence in the financial markets and to prevent manipulation of financial indices.

The BMR came fully into force in January 2018. It builds on the IOSCO principles for financial benchmarks and applies to any benchmark administrator established in the EU. The BMR aims to ensure benchmarks are robust, reliable, and to minimize conflicts of interest in benchmark-setting processes. It also requires the administrator of critical benchmarks (in practice certain IBORs) to ensure that all users are granted access on a fair, reasonable, transparent and non-discriminatory basis.

The BMR defines an index as a figure that is publicly available and is regularly determined, either by applying a formula or other calculation method or by making an assessment based on the value of one or more underlying assets/prices. Underlying assets and prices could include estimated prices, actual or estimated interest rates, quotes and committed quotes, or other values or surveys. An index becomes a benchmark within the scope of the BMR where it is used to determine the amount payable under a financial instrument or contract or the value of it. An index also becomes a benchmark if it is used to measure the performance of an investment fund to track the return, defining the asset allocation, or computing performance fees.

Investment funds have not contributed to the manipulation of (systemically important) financial indices (e.g. Libor, Euribor). Fund management companies do not provide input data for the calculating of (systemically important) benchmarks. Asset managers are mainly users of benchmarks/market indices. Fund management companies do not have access or the ability to influence the process of creating (systemically important) benchmarks or financial indices provided by index providers. Asset managers

¹ BVI represents the interests of the German fund industry at national and international level. The association promotes sensible regulation of the fund business as well as fair competition vis-à-vis policy makers and regulators. Asset managers act as trustees in the sole interest of the investor and are subject to strict regulation. Funds match funding investors and the capital demands of companies and governments, thus fulfilling an important macro-economic function. BVI's 116 members manage assets of some EUR 4 trillion for retail investors, insurance companies, pension and retirement schemes, banks, churches and foundations. With a share of 28%, Germany represents the largest fund market in the EU. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.



are not able to manipulate these benchmarks, even if they can be used to measure the performance of an investment fund.

Asset managers represent an important group of benchmark users. Index funds and Exchange Traded Funds (ETFs) use benchmarks to construct portfolio baskets targeting an index. Active managers also use benchmarks to construct a portfolio and/or to measure performance against a selected index or a set of indices. The German investment fund management companies use both public and customized indices and benchmarks provided by index providers which follow their own methodology in respect of use of real transactions, tradable prices, quotes and offered rates. Panel submissions and estimates are only used if no real transaction data are available.

German investment funds have to respect the following BMR requirements:

- **Benchmark cessation plans**

The introduction of the legal obligation to use cessation/contingency plans (Article 28 para 2 BMR) in 2018 has clearly enhanced the compliance and reporting burden for the German fund industry without additional value for the regulators. The (German) fund industry had already implemented complex cessation/contingency plans for investment funds (UCITS/AIFs) that use indices in accordance with Article 3 (1) No. 7 (e) BMR.

Therefore, the German fund industry was/is well prepared for the provision of contingency plans for investment funds as the selection and determination of (alternative) financial benchmarks is a well-established process in the fund, risk and product management of a fund management company. The ESMA “Guidelines on ETFs and other UCITS issues” of 2012² subjects investment funds (UCITS/AIF) to stringent and extensive due diligence obligations on the use of financial indices. The ESMA Guidelines foresee that only transparent indices are permitted for UCITS to be used as a benchmark. These transparency requirements are very extensive and cover calculation, re-balancing methodologies, as well as constituents and their respective weightings. Furthermore, part of those rules relates to the disclosure of information on the indices settings to the end-investors (in the UCITS KIID).

(German) fund management companies are subject to two different regulatory compliance obligations (e.g. EU BMR and the ESMA Guidelines) with the same regulatory aim. The different legal obligations require changes to the fund documents, thereby enhancing the legal complexity for the fund management companies. Additionally, benchmark administrators do generally not provide the information which is deemed necessary to comply with said ESMA Guidelines in a transparent, fast, efficient and user-friendly way to the fund industry.

Fund management companies have to rely on the willingness of the benchmark administrators to provide all relevant information, including information on possible alternative benchmarks. Asset managers are obliged to search, screen, and monitor all relevant administrator websites enabling them to identify the relevant benchmark information. Such additional requirements enhance the operational complexity for the supervised entities as fund management companies are obliged to obtain such information.

² https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-2014-0011-01-00_en_0.pdf



We therefore take the view that benchmark administrators should be legally required to provide benchmark-related information (e.g. calculation, re-balancing methodologies, constituents and their respective weightings, available alternative benchmarks for cessation/contingency plans) to the supervised entities, thereby enabling them to comply with their applicable regulatory requirements. In the context of the updated publication of cessation plans of alternative benchmarks within the fund documents (e.g. UCITS prospectus) our members fear that the concrete naming of alternative indices could trigger the conclusion of new and complex license agreements with the corresponding index provider.

Fund management companies are forced to conclude extensive, complex and overpriced license agreements with the index providers in order to use the indices for internal (e.g. portfolio and risk management) and external purposes (e.g. institutional reporting and fund documents).

The BMR requirement to set up additional cessation plans within the fund documents have further increased the legal and compliance cost for the fund management companies without any additional protection for the European investors. Such an obligation has also put the investment fund industry at a disproportionate compliance burden compared to the Sell-Side (e.g. credit institutions, broker/dealers) as such institutions need to comply only with the BMR cessation plans.

- **Use of benchmarks**

Supervised entities such as German fund management companies are only allowed to use benchmarks or a combination of benchmarks within regulated investment funds (UCITS/AIFs) if the benchmark is provided by an administrator located in the EU or third country administrators/benchmarks and included in the ESMA register. The time and effort associated with the task to search, identify and monitor on a regular basis the ESMA register containing thousands of indices allowed for use by EU administrators and third country benchmarks is huge. It obliges asset managers to set up the operational capacities internally to ensure the use of valid benchmarks only. Such increased compliance burden is not in line with the principle of proportionality compared to EU credit institutions which do not have to check such a big volume of EU administrators and third country benchmarks.

We have made concrete proposals³ to modernize the EU benchmark framework in view of strengthening the global competitiveness of the EU financial service industry based on a more balanced approach in respect to the compliance rules for supervised entities and benchmark administrators. Currently, the EU is the only region worldwide which has implemented stringent benchmark rules compared to the US and other countries around the globe.

³ https://www.bvi.de/fileadmin/user_upload/200807_BVI_position_review_BMR.pdf



2. Please provide details how the costs associated with utilising a particular index / index provider are disclosed to investors in the fund / investment product. For example, please clarify if there are any circumstances under which the specific costs associated with using a particular index are broken out apart from other fees and expenses. Please outline if you are aware of any confidentiality provisions or contractual terms which may be currently imposed that would prevent such fee disclosures.

Please see our answer to question 1. Generally, benchmark providers do not provide the required cost information to a particular index in a transparent, fast, efficient and user-friendly way to the fund industry which are deemed to be necessary to comply with the above-mentioned regulation (BMR and ESMA guidelines).

The consultancy Substantive Research conducted a study based on buy side index data user with the following trends in respect to cost:⁴

- Pricing is not consistent – there is large variance in pricing and little or no correlation to the size of the firm consuming the market data. Even accounting for specific “apples-to-apples” use cases, the range of inconsistencies applied to pricing post-negotiation is between 10% and 50%.
- Buy-side budgets vary from 0.55bps to 1.27bps of AUM – this is one of the largest costs of doing business for an asset manager and it is increasing materially Year over Year.
- Average potential savings per provider are \$360k – and with many institutions using a long list of providers, this figure scales up rapidly.

Specifically, the opacity of the index market is evident in the large pricing disparities between wholesale market data buyers with similar use cases:

- The pricing that buy-side institutions receive for supplying a single index from the same provider differs by an average dispersion of 21% – the overall range from lowest price to highest price can be as high as 219% (some institutions are paying more than twice as much as peers).
- For reporting licenses, the average dispersion in pricing can be up to 37% – the range from lowest to highest can be as high as 472% (some institutions are paying almost five times more than their peer group).
- Average spend on index products per provider can be broken down into 44% spent on licenses and 56% spent on the underlying benchmarks – and licenses are where the greatest price variability occurs for similar use cases.

Fund management companies rely on the willingness of the benchmark administrators to provide all relevant cost information, including information on possible (alternative) benchmarks.

Asset managers are obliged to search, screen, and monitor all relevant administrator websites enabling them to identify the relevant index cost information. Such additional requirements enhance the operational complexity for the supervised entities as fund management companies are obliged to obtain such information. Index providers does not allow the usage of concrete naming and prices/costs of

⁴ <https://substantiveresearch.com/press-archive/substantive-research-exposes-market-data-pricing-inconsistencies/>



(alternative) indices in the fund documents/prospectus without triggering the conclusion of new and complex license agreements with the corresponding benchmark providers.

3. Where you are fully or partially responsible for the choice of an index to manage against, please outline your due diligence processes to assess the appropriateness of the index for your client/target market both at the outset and on an ongoing basis?

Please see our answer to question 1. German asset managers have to adhere to a complex due diligence process to assess the appropriateness of a given index for their client/target market both at the outset and on an ongoing basis due to the EU BMR and ESMA guideline obligations.

4. Please provide details of products where you have engaged with an index provider to create a bespoke benchmark? Please elaborate on why you would engage with an index provider to create a benchmark instead of selecting a pre-existing benchmark or opting to actively manage the portfolio. Where does the responsibility for the operational performance of the index lie contractually and where, in practice, do you think responsibility does lie?

Usually, bespoke benchmarks are individually agreed between fund managers and a very limited number of (institutional) investors according to the specific needs of the latter ones. A bespoke benchmark may be also imposed on the asset manager by their client wishes/demands. Therefore, customized/bespoke indices are targeting the personalized objectives and strategies of a particular investor. They do not present the systemic risks and regulatory concerns of benchmarks publicly available for a large number of users as they implement only a specific risk/return profile of a particular investor as long as the underlying index is well regulated and transparent.

In many cases, those indices are referenced only by one investment fund/sponsor or a restricted number of investment funds and are related to their restricted group of investors. The composition of the benchmark being fully transparent by the asset manager to the investor (but only to him/her) along with the fact that the benchmark is based on an existing regulated benchmark minimize any risk of manipulation or conflicts of interest.

These indices are in most cases not made available by the investment fund to the public. However, some more widely used variations of originally “bespoke” indices which have been used over time by many institutional investors are usually broadcasted by the benchmark providers themselves, e.g. a broad stock index expressed in another currency than its home market currency, in which case they are made available to the public.

Therefore, asset managers engage with index providers to create a customized benchmark according to the preference of the investor instead of selecting a pre-existing benchmark or opting to actively manage the portfolio. Furthermore, index providers do not allow the combination of different indices (e.g. equity and fixed income in the case of balanced funds) from the same benchmark providers.

The responsibility for the operational performance of the indices lies contractually and in practice with the index data user as at least the dominant brand index providers regularly exclude liability to the extent possible for any mistakes in the calculation and management of the index as well as for the provision of timely and correct index data.



5. In addition to the topics / questions addressed below, are there any other areas which you think IOSCO should consider as part of its work on conduct-related index provider matters.

We welcome the initiative started by IOSCO and its members (e.g. ESMA, FCA, SEC) to analyse and address the significant issue of ever-increasing market, benchmark and rating data costs. Authorities need to recognize and act upon the fact that exchanges, rating and index providers hold disproportionate market power on these data. All these data pricing, licensing practices, including terms & conditions definitions, audit procedures and connectivity fees should all be subject to regulatory oversight. We therefore welcome all future regulatory action to monitor and control the increase of cost in financial data (including market-, benchmark- and rating data) to support vibrant and active capital markets where participants of all sizes may conclude transactions based on transparent data.⁵

- **Response to regular and exceptional events**

1. Please describe your internal governance arrangements and policies for responding to regular and exceptional events which result in challenges managing against and / or in tracking a particular index. Please separately detail these for ‘regular’ events (such as corporate actions, etc.) and ad-hoc exceptional events (such as external shocks such as the Russian / Ukraine market shock).

Please see our answer to question 1 (General). According to the EU regulation (EU-BMR and ESMA guidelines), German fund management companies have to regularly monitor the usage of the respective benchmarks in the UCITS/AIFs independently if a “regular” or “ad-hoc” exceptional event occurs.

Our members have generally not witnessed during “ad-hoc” exceptional events significant disruptions of indices provided by the regulated benchmark providers. Therefore, our members never had to activate the cessation plans according to the EU BMR.

2. Please provide details about the extent to which you engage with index providers during such events (and specifically what concrete engagement took place during the Russian / Ukraine market shock).

Please see our answer to question 1 (Response to regular and exceptional events).

⁵ <https://www.bvi.de/en/positions/financial-market-data/>



3. Please also provide details of the following:

a. Did you change your processes with respect to index tracking during this period?

b. Please provide any information on any index changes or rebalancing holidays during this period (for example, their duration, information on the interaction and decision making process around declaring a rebalancing holiday between index providers and asset managers, including how potential conflicts of interest among them may have been managed).

Please see our answer to question 1 (Response to regular and exceptional events).

- **Errors**

1. Did you experience any errors in the compilation of an index caused by an index provider? If so, please elaborate on the circumstances surrounding the error (e.g. the source of the error – human error, IT related, etc). What impact did this have on your business and that of the funds under management (or other underlying products as may be relevant)? For example, was there any necessity to pay financial compensation or redress of some form?

As asset managers, several ETF issuers and index fund managers have experienced instances of index calculation errors by the benchmark administrator, especially during volatile trading environments. There is increasing evidence highlighting how these errors have not been detected by the index providers themselves, yet the quality of an ETF's (or an index fund's) replication has suffered as a result, through greater tracking error and ultimate harm to investors. Users of these indices note how there are presently no liability clauses holding index administrators responsible for these sorts of errors. Moreover, there are various disclaimers in the relevant index use terms and licensing agreements to limit the administrator's responsibilities in this regard.

Therefore, we strongly encourage IOSCO and their members to take adequate regulatory steps that all index providers should be made strictly liable for any error in the compilation of an index caused by an index provider. Benchmark providers have to delete any disclaimers to the contrary in the license agreements concluded with their clients (e.g. fund management companies).

2. What type of arrangements (e.g. contractual or otherwise) are in place to manage such errors?

The responsibility for the operational performance of the index lies contractually and in practice with the index data user as at least the dominant brand index providers regularly exclude liability to the extent possible for any mistakes in the calculation and management of the index as well as for the provision of timely and correct index data.

- **Conflicts of interest**



1. Please provide details of the extent to which you perform self-indexing and/or have an affiliated index provider. What are the potential conflicts of interest that may arise? Please also detail how potential conflicts of interest are managed in such cases (e.g., information barriers, etc.).

Asset managers are mainly users of benchmarks/market indices. Fund management companies do not have access to or the ability to influence the process of creating (systemically important) benchmarks (BM) or financial indices provided by index providers. Asset managers are not able to manipulate these benchmarks, even if they can be used to measure the performance of an investment fund. Fund management companies under AIFMD/UCITS in the EU are not allowed to take out separate BMR benchmark administrator licenses.

2. Are there other situations that may give rise to potential conflicts (e.g., where an index provider invests in the fund or provides seed funding)? Please also detail how potential conflicts of interest are managed in such cases.

There are no such situations to date.

3. Do you consider that conflicts of interest may arise where both an index and an investment fund tracking that index use the same pricing information? What processes are in place to effectively manage such conflicts? Please explain the nature of the potential conflicts, how they are avoided, managed and disclosed. Where possible, please provide examples of how such conflicts were managed during recent exceptional market events.

EU based investment funds are required by law under AIFMD/UCITS Directive to use only vetted pricing sources, especially exchanges, and to follow specified valuation procedures which are subject supervisory and auditor surveillance. There should not be any unmanaged conflicts of interest situations.

4. Do you provide any disclosure of any affiliations or potential conflicts of interest that might arise? If so, please provide details of that disclosure.

No. Please see our answers as given above.

- **Services / functions utilised**



1. Please provide details of any services or functions you utilise from index providers in addition to the core function of index provision or administration. Do you consider that such services or functions raise any particular issues (e.g. conflicts, operational, etc.)?

- **Keep data unbundling**

The user side (e.g. fund management companies) of benchmark market data should only pay for data they are interested in rather than being forced to buy additional services. Benchmark data providers should always inform customers that the purchase of the benchmark is available separately from the purchase of additional data (for example license for constituents). Furthermore, benchmark data providers should not condition the purchase of individual benchmarks to the purchase of a broader range of benchmarks (in which there may be little interest). Similarly, double licenses should be avoided when the same benchmark is used as a single benchmark or in combination with another benchmark.

2. Where an index provider provides non-core services, such as Environmental, Social or Governance (ESG) screening services, do any particular challenges or difficulties arise? For example, where such screening does not form part of the index's rules, could this result in the index being less transparent? On the other hand, where such screening forms part of the index's rules, could this result in a higher level of discretion being exercised by the index providers? Are there any measures adopted by the asset managers to ensure such discretion are bounded within certain limits?

Our members have not witnessed any difficulties.