

May 16, 2013

Mr. Alp Eroglu  
International Organization of Securities Commissions (IOSCO)  
Calle Oquendo 12  
28006 Madrid  
Spain

Re: Consultation Report CR04/03 on Financial Benchmark Principles

Dear Mr. Eroglu:

The Investment Company Institute<sup>1</sup> and ICI Global<sup>2</sup> appreciate the opportunity to comment on IOSCO's Consultation Report on Principles for Financial Benchmarks (the "Consultation").<sup>3</sup> 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") (collectively "regulated funds"<sup>4</sup>). Many invest in fixed income instruments and trade in financial contracts referenced to survey-based benchmarks such as LIBOR and EURIBOR,<sup>5</sup> and some also manage funds that are designed to track

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<sup>1</sup> 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 \$14.96 trillion and serve more than 90 million shareholders.

<sup>2</sup> 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.

<sup>3</sup> The Board of the International Organization of Securities Commissions, *Consultation Report CR04/03 on Principles for Financial Benchmarks*, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD409.pdf>.

<sup>4</sup> "Regulated fund" refers to mutual funds, closed-end 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 Transferable Securities ("UCITS"), or elsewhere in the world under similar regulatory regimes.

<sup>5</sup> A "survey-based benchmark" is calculated based on surveys or other subjective estimates that are submitted to the benchmark provider.

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the performance of commercial indices (“index funds”).<sup>6</sup> As both investors in financial instruments and contracts that reference benchmarks and licensees of commercial indices on which index funds are based, ICI and ICI Global members have a strong interest in IOSCO’s recommendations on financial benchmarks.

We support IOSCO’s two-tiered approach to developing principles for financial benchmarks. As we explained in a letter on IOSCO’s January 2013 Consultation on Financial Benchmarks,<sup>7</sup> one size does not fit all when it comes to the regulation of benchmarks. In particular, we believe numerous and important distinctions can be drawn between survey-based benchmarks and commercial indices.<sup>8</sup> We therefore applaud IOSCO for recognizing that the universe of benchmarks is large and diverse, and for addressing its more detailed principles only to those that have demonstrated specific risks, such as survey-based benchmarks. While we continue to urge regulators to focus their resources on addressing these identified risks,<sup>9</sup> the proposed high level principles generally reinforce good governance, accountability, and index quality practices, the benefits of which inure to ICI and ICI Global members as licensees of commercial indices, and by extension to their investors.

We continue to be concerned, however, about the potential for unnecessary regulation, and the impact such regulation could have on funds and their investors. We strongly support IOSCO’s view that the principles be understood as a set of recommended practices. Still, IOSCO’s recommendation that its members consider regulatory action to encourage implementation of the principles could result in regulatory approaches that could impose unnecessary costs on, and cause related harms to, the commercial index market, particularly if such regulations are inconsistent across IOSCO member

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<sup>6</sup> A “commercial index” is an index that is licensed for a fee, such as the S&P 500 or FTSE 100. The data for such 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.

<sup>7</sup> 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>.

<sup>8</sup> See Letter from Karrie McMillan, General Counsel, Investment Company Institute, and Dan Waters, Managing Director, ICI Global, to Alp Eroglu, International Organization of Securities Commissions, dated Feb. 11, 2013, available at <http://www.ici.org/pdf/27001.pdf> (“February Letter”). See also “Best Practices for Better Benchmarks,” BlackRock Viewpoint, March 2013, available at [https://www2.blackrock.com/webcore/litService/search/getDocument.seam?venue=PUB\\_IND&source=GLOBAL&contentId=1111183640](https://www2.blackrock.com/webcore/litService/search/getDocument.seam?venue=PUB_IND&source=GLOBAL&contentId=1111183640) (detailing differences between “rate benchmarks” and “market indices”).

<sup>9</sup> See, e.g., 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>; 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> (“ICI/ICIG Letter to European Commission”); and Letter from Dan Waters, Managing Director, ICI Global, to Steven Maijoor, Chairman, European Securities and Markets Authority, and Andrea Enria, Chairman, European Banking Authority, dated February 13, 2013, available at [http://www.iciglobal.org/pdf/13\\_icig\\_esma\\_benchmarks.pdf](http://www.iciglobal.org/pdf/13_icig_esma_benchmarks.pdf).

jurisdictions. We urge IOSCO to recommend that its members take these potential harms into account when assessing the need for regulation.

Our comments on the Consultation follow. In Part I, we offer general comments on the high level principles that apply to commercial indices, and set forth our concerns with respect to possible regulatory actions by IOSCO members to implement these principles. In Part II, we address in more detail certain principles that have a more direct impact on index fund managers – those dealing with the quality of benchmarks and methodologies. Finally, in Part III, we briefly address the more specific principles offered for survey-based benchmarks and those with ownership structures that may create conflicts of interest.

### **I. High Level Principles – Benefits and Potential Risks of Regulatory Implementation**

ICI and ICI Global members concur that the proposed high level principles constitute good recommended practices for benchmark administrators. Indeed, with respect to the commercial indices commonly licensed by managers of regulated index funds, we believe many of these practices are already in place. As we explained in more detail in a letter to the European Commission on its consultation on the regulation of indices, the commercial index business is extremely competitive.<sup>10</sup> Fund managers select their indices subject to careful diligence, and based on a wide range of factors. These factors include the market the index measures and its formula for doing so, as well as the management and governance of the benchmark administrator. Further, fund managers can and do change indices for a variety of reasons,<sup>11</sup> and would presumably do so if they believed these factors were compromised. We continue to believe these market forces are by far the most effective regulator of commercial index administrators, but the recommended practices may have an additive effect.

While we agree that the high level principles represent good practices for index administrators, we do not believe that additional regulation is warranted with respect to commercial indices.<sup>12</sup> As we explained in our February letter, IOSCO and other regulatory bodies that have examined financial benchmarks have not identified any concerns specific to such indices that warrant regulatory intervention. In the absence of any identified problem or tangible benefit that would result from regulation, imposition of the costs associated with regulation seems unjustified.

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<sup>10</sup> See ICI/ICIG Letter to European Commission, *supra* note 9, commenting on the European Commission's *Consultation Document on the Regulation of Indices*, September 5, 2012, available at [http://ec.europa.eu/internal\\_market/consultations/docs/2012/benchmarks/consultation-document\\_en.pdf](http://ec.europa.eu/internal_market/consultations/docs/2012/benchmarks/consultation-document_en.pdf).

<sup>11</sup> See, e.g., Olly Ludwig and Cinthia Murphy, "Vanguard to Drop MSCI Index on VWO," *IndexUniverse*, Oct. 2, 2012, available at <http://www.indexuniverse.com/sections/features/14699-vanguard-to-drop-msci-index-on-vwo.html>.

<sup>12</sup> Our views on the proposed principles with respect to survey-based benchmarks are discussed *infra* notes 15-18 and accompanying text.

In the case of commercial indices, such costs would ultimately flow through to regulated funds that license the use of their indices and ultimately, their investors. In addition to direct costs, such as those reflected in higher fees, these costs include new barriers to entry and potential consolidation that would reduce competition and stifle the development of new and innovative market indices and indexing techniques.<sup>13</sup> We are particularly concerned with the potential costs if IOSCO members took different regulatory approaches to encourage implementation of the principles, such that indexes used across multiple jurisdictions (as many are) could be subject to potentially conflicting regulations.

We recommend that IOSCO's final report acknowledge the risks of unnecessary regulation. The Consultation provides a list of factors that IOSCO members should consider in determining whether regulatory action may be appropriate to encourage implementation of the principles; we note that one such factor is "the need for and likely effectiveness of any policy changes." To further highlight our concerns, this list could be revised to include "the impact of potential regulation by IOSCO members on the market for commercial benchmarks." The final report could also recommend that to the extent IOSCO members contemplate regulatory action, they should seek to coordinate with one another to ensure maximum consistency across jurisdictions.

## **II. Principles Relating to the Quality of Benchmarks and Methodologies**

As licensees of commercial indices for the purpose of managing index funds, the quality of these benchmarks is of utmost importance to ICI and ICI Global members, because their products – the fund shares they manage – are closely tied to the performance of the benchmark. Likewise, we have a distinct interest in the methodologies of licensed indices, since they largely dictate the investment actions taken by an index fund manager. We generally support IOSCO's proposed principles in these broad categories, and offer the following comments with respect to commercial indices.

### *a. Principles Relating to the Quality of the Benchmark*

We support IOSCO's approach to promoting the quality and integrity of benchmark determinations. The proposed principles in this category, which focus on benchmark design and data sufficiency, are consistent with the factors ICI and ICI Global members consider when evaluating benchmarks, both before an initial subscription and on an ongoing basis.

In particular, we applaud IOSCO's recognition that a variety of data may be appropriately used to construct a benchmark, as long as the data sufficiency principle is met. We agree that, ideally, such data should be anchored by observable transactions entered into at arm's length between buyers and sellers in the market for the interest the benchmark measures. In some markets, however, particularly with respect to fixed income, certain instruments trade so infrequently that the last transaction price

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<sup>13</sup> 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](http://ec.europa.eu/internal_market/consultations/2012/benchmarks/individual-others/vanguard_en.pdf).

may not reflect their current value. In these cases, actionable bids and offers, as well as modeled price estimates, may more accurately reflect current market value than the last concluded transaction. Fund managers regularly monitor benchmark pricing, taking into account the potential limitations of non-transaction-based data, and they demand the same attention from the benchmark's administrator.

*b. Principles Relating to the Quality of the Methodology*

Similarly, we agree with IOSCO that sufficient information should be available to stakeholders to enable them to understand and make their own judgments about the credibility of a benchmark, including information about material changes to a benchmark. As managers of financial instruments that reference a benchmark, ICI and ICI Global members have a strong interest in ensuring that their investors understand the investment objective and strategy of the fund. IOSCO's proposed principles on the content of and changes to the methodology recommend the publication of substantial, useful information to investors and other stakeholders.

At the same time, we appreciate that these principles do not appear to recommend complete disclosure of the methodology. As we explained in our February Letter, requiring the publication of information sufficient to allow interested parties to replicate a published benchmark, as IOSCO's January consultation suggested, would have significant negative consequences, including the potential for "front running" and "free riding" of the index, along with damage to the value of administrators' intellectual property, and resulting damage to the livelihood of the commercial index market.<sup>14</sup> We believe the proposed principles on methodology protect against these risks.

**III. Principles Specific to Survey-Based Benchmarks and Certain Ownership Structures**

*a. Principles Specific to Survey-Based Benchmarks*

ICI and ICI Global members collectively manage over \$5 trillion in fixed income and money market instruments, and trade in financial contracts such as futures, forwards, options and swaps. Many of these instruments contain terms that reference LIBOR or other survey-based benchmarks. ICI and ICI Global members and their investors therefore have a compelling shared interest in ensuring that such benchmarks are robust and accurate.

ICI and ICI Global have consistently supported efforts to reform the process for establishing LIBOR and other survey-based benchmarks.<sup>15</sup> In particular, we have supported measures that could strengthen the credibility of those benchmarks, make the rate-setting process more fact-based and transparent by using transaction data to the greatest extent possible, and improve governance over rate submissions and calculations. IOSCO's proposed principles relating to survey-based benchmarks,

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<sup>14</sup> See February Letter, *supra* note 8.

<sup>15</sup> See letter from Paul Stevens and Dan Waters to The Wheatley Review, *supra* note 9.

including establishing a control framework and internal oversight, an audit trail, and a submitter code of conduct, further promote these objectives.

We also welcome IOSCO's approach to improving, rather than replacing, these benchmarks. As we explained in a letter to the Wheatley Review, ICI and ICI Global members are skeptical about the potential for developing a workable alternative benchmark to replace LIBOR.<sup>16</sup> More importantly, even if an appropriate benchmark were developed, we have deep concerns about any regulatory approach to compelling migration to any new benchmark, particularly if the approach includes the abolishment of existing benchmarks.

As a preliminary matter, the economic terms in any contract are a matter of choice for the parties to that contract; a regulatory prohibition on the use of any benchmark would impede the rights of contracting parties. There are also practical implications of migration, such as the necessity of renegotiating existing contracts to reflect the new rate, a process that would be protracted, consume significant resources, and present serious operational challenges. Finally, any non-voluntary migration would likely cause substantial market disruption in the fixed income markets as well as harm to individual issuers and investors. For example, many floating rate corporate bonds reference LIBOR. It is unclear how the markets would treat such instruments if their embedded reference rates were suddenly shifted, and any holders of such securities would likely be exposed to extreme volatility and other risks.

*b. Principles Specific to Certain Ownership Structures*

We applaud IOSCO's approach of developing specific principles to address potential conflicts of interest that may arise in certain ownership or organizational structures. These may include instances in which affiliates of benchmark administrators or submitters may have an interest in the benchmark calculation, or in which activities relating to benchmark determination are undertaken by third parties, who may have other interests affected by the benchmark rate. Recent events have demonstrated that unaddressed conflicts of interest can lead to inappropriate conduct in the benchmark setting process.<sup>17</sup> As we explained in our February Letter, however, not all benchmarks are equally susceptible to such conduct.<sup>18</sup> Thus, the application of specific principles only in circumstances where such conflicts may arise is a sensible approach.

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<sup>16</sup> *Id.*

<sup>17</sup> As we noted in our February letter, in the United States, the Securities and Exchange Commission has carefully considered the potential for such conflicts in the context of ETFs that track indices provided by an affiliate, and has permitted these arrangements subject to certain conditions. *See* February Letter at note 16 and associated text.

<sup>18</sup> Specifically, the February Letter, as well as the ICI/ICIG Letter to European Commission, explained that there is neither opportunity nor incentive for asset managers or other stakeholders to manipulate commercial securities indices. *See also* Vanguard Letter to European Commission, *supra* note 13.

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We appreciate 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

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