

# Benchmark-Linked Investment Products

## Risks for Investors and the Markets

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Americans for Financial Reform  
Convening on Investment Company Regulation  
December 3, 2019, 1:30 pm EST



**HEALTHY MARKETS**  
TRANSPARENCY & TRUST



Tyler Gellasch Executive Director

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# Benchmark - Linked Investments

## What are we talking about?

*Benchmark-linked investment products generate returns linked to the performance of benchmarks that, in turn, are designed to reflect measures of prices, rates, or other data points.*

*These benchmarks may be outputs from complex, proprietary formulas or simply references to public rates or trading prices.*

# What are the advantages of benchmark-linked investments?

- **Potentially greater access to thematic, geographical, or sector products**
  - Easier to buy the “basket” than pick amongst components (e.g., MSCI Emerging Markets Index)
  - Link to complex concepts with multiple inputs like “average” “interest rates” (e.g., LIBOR or SOFR).
- **Potentially easier to monitor and track track**
  - Invest in one product versus several components and rely on associated risk profile of one product versus several (e.g., SPY versus components).
- **Potentially easier and more cost-effective to trade**
  - Instead of executing dozens or hundreds of trades, may execute one.

# What are the disadvantages of benchmark-linked investments?

- **Methodology concerns**

- Is the index an accurate reflection of the exposure you want?
- Does it do what we think it does (e.g., VIX products)?

- **Integrity concerns**

- Is it manipulatable (e.g., LIBOR and FX products)?
- Are there hidden costs (e.g., UBS case)?
- What conflicts of interest are there for the index creator, seller, and administrator?
- What is the discretion provided for the index creator, seller, and administrator, and how can that impact the performance and risks?
- What does the governance of the index look like at outset and over time?
- What arbitrage opportunities and potential abuses does it create? For whom?

# What are the disadvantages of benchmark-linked investments?

- **Accountability concerns**

- How can an investor oversee it and ensure accuracy?
- Is the benchmark able to be back-tested and audited?

- **Systemic concerns**

- Is the tail wagging the dog? Is this informed capitalism?
- Investment quality control (e.g., fixed income issuers now tailor offerings to meet index criteria, which may be more impactful than credit ratings)?
- Does this spur investment in sub-optimal areas and create liquidity and allocation mismatches?
- Does this increase concentration?

“In 2018, more than \$13.9 trillion in investment funds had stock portfolios that mimic the composition of MSCI indexes or used them as performance yardsticks, and nearly all investments by U.S. pension funds in global stocks are benchmarked against MSCI indexes.”

-Wall St. Journal, Feb. 3, 2019

# Concrete Concerns

LIBOR Manipulation Cases

Foreign Exchange Manipulation Cases

ISDAFIX Manipulation Cases

UBS Bespoke Index Case

Commodities Manipulation Cases

MSCI Emerging Markets Index\*

\*Not an enforcement case



# Example: MSCI Emerging Markets Index

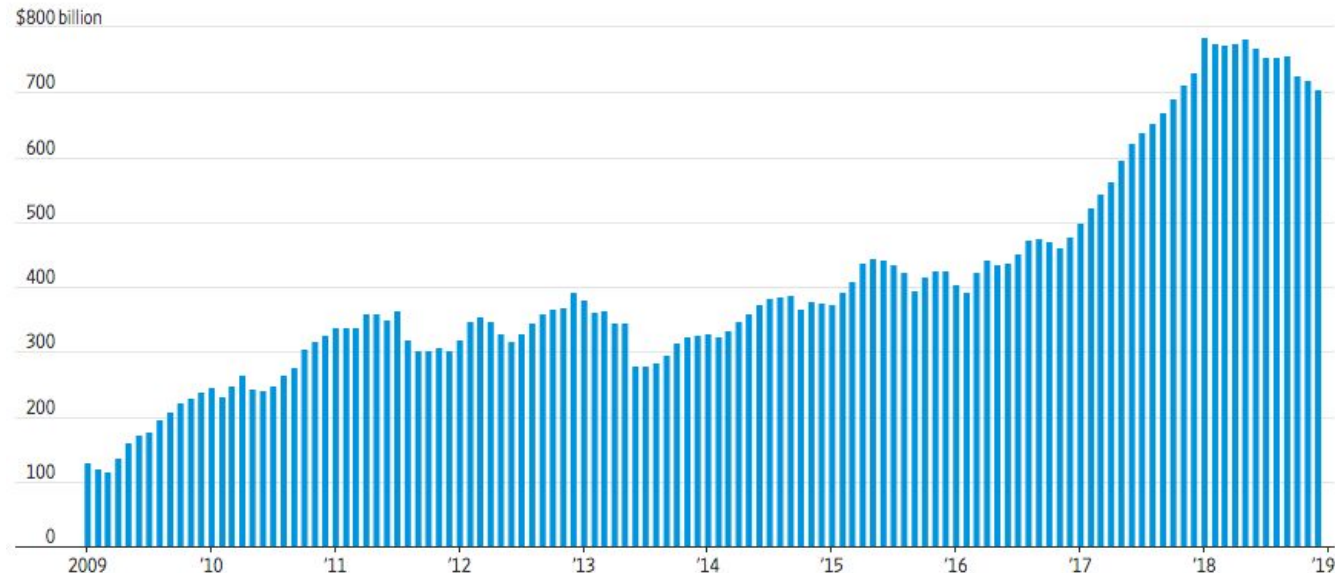
## How China Pressured MSCI to Add Its Market to Major Benchmark

The move raises questions about the independence of MSCI as the index giant wields increasing market power

### Supersized

The amount invested in exchange-traded funds linked to MSCI indexes has boomed.

### Assets under management

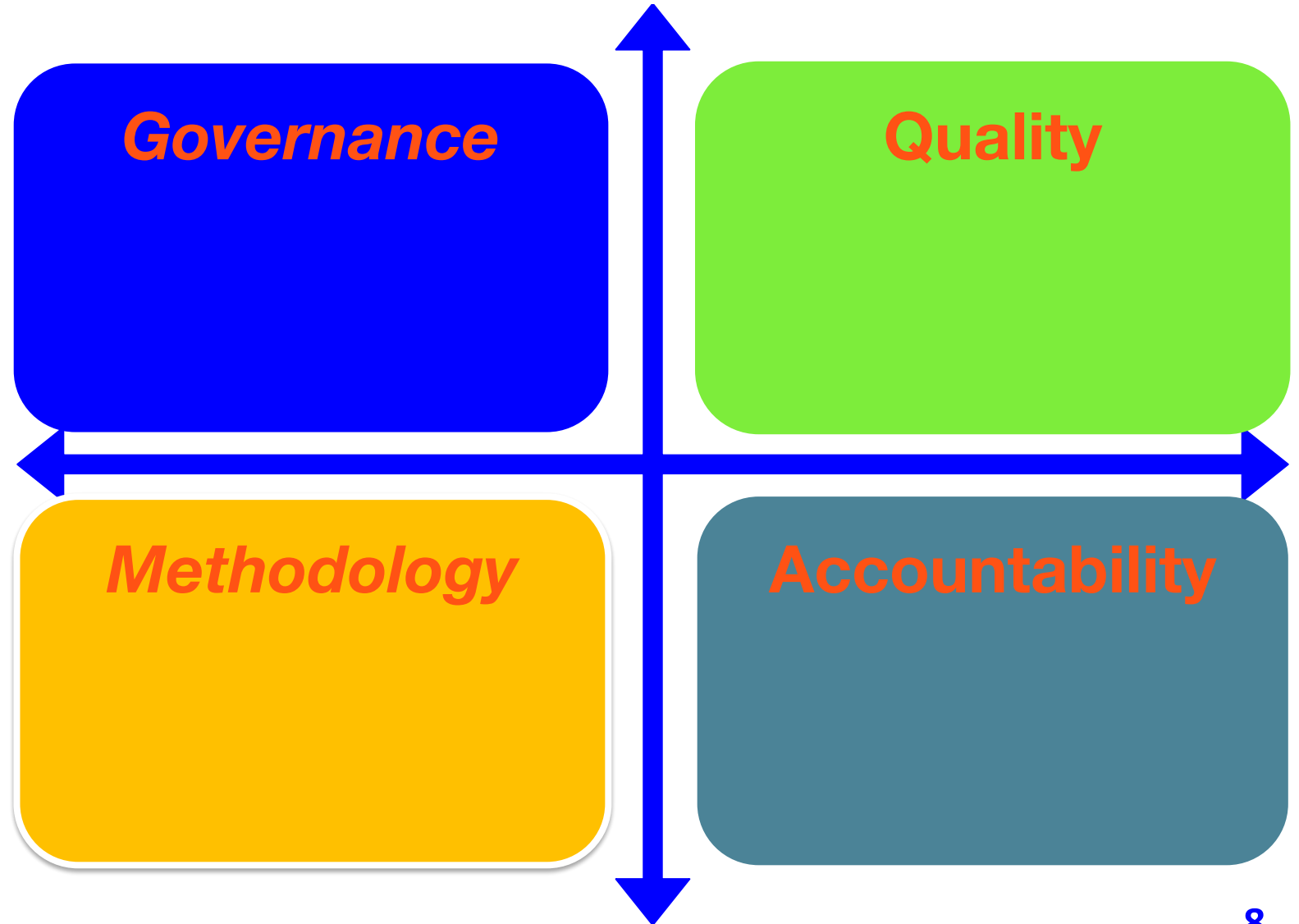


Source: MSCI



***What's Really in Your Index Fund?***

# European Approach: IOSCO Principles and Benchmark Regulation



Are the indexes:

- (1) Critical,
- (2) Significant, or
- (3) Non-significant?



# US Approach: Enforcement and Contemplation

***\*\*\*Despite widespread manipulation of indexes underpinning hundreds of trillions in investments, rampant conflicts of interest, and opportunities for hidden fees and abuses, no US regulator has proposed reforms to direct oversight of benchmarks themselves.\*\*\****

*HOWEVER.....*

## Speeches and Statements

- **SEC Chairman Jay Clayton Remarks at IAC and FIMSAC** (<https://www.sec.gov/news/public-statement/clayton-remarks-investor-advisory-committee-110719> and <https://www.sec.gov/news/public-statement/statement-clayton-fimsac-110419>)
- **SEC Inv. Mgmt Division Director Dalia Blass Speech** (<https://www.sec.gov/news/speech/speech-blass-2018-03-19>)
- **SEC Commission Robert J. Jackson, Jr. op-Ed in NY Times** (<https://www.nytimes.com/2019/02/18/opinion/index-fund.html>)
- **CFTC Commissioner Brian Quintenz Remarks**

## SEC Risk Alert (Nov. 8, 2018)

- [https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20RI C%20Initiatives\\_0.pdf](https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20RI C%20Initiatives_0.pdf)

## IOSCO Principles for Financial Benchmarks (2013)

- <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf>

## SEC OCIE 2019 Examination Priorities

- <https://www.sec.gov/files/OCIE%202019%20Priorities.pdf>

## Market Participants and Experts Beginning to Push for Reforms

- **Healthy Markets Association March 2019 Report** (<https://healthymarkets.org/product/benchmark-linked-investments>)

# Self-Help Is All We Have Now

## Protecting Investors in the United States

Investors and other market participants in the United States and abroad would be well-advised to perform significant due diligence, including:

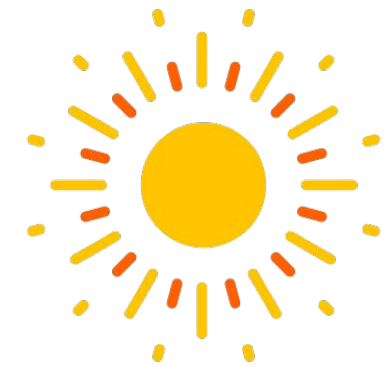
- Is the benchmark an accurate reflection of the exposure I want?
- Will the benchmark remain an accurate reflection of the exposure I want over time?
- Is the benchmark easy to manipulate?
- If the benchmark uses data from other parties, is that data provided voluntarily or compelled?
- If the benchmark uses trade-related information, is it based on actual trading or on quotes?
- Are those inputs taken at specific, known times or are they randomized?
- What procedures exist to ensure that the inputs are an accurate reflection of the markets which they are purporting to measure (e.g., are data snapshots randomized, are multiple samples taken, or are outliers excluded)?
- Are the benchmark criteria objective, subjective, or a mix?
- Are the benchmark criteria and calculation methodologies public, auditable, and testable?
- How may a ratings agency or other party assess the risk associated with the benchmark or its linked investment products?
- How can the benchmark calculation or inputs be changed over time?
- How are costs for creation and maintenance of the benchmark determined and allocated?
- If the benchmark is linked to a public reference point, is there an investment performance shortfall? If so, why?
- How are the costs for the benchmark-linked investment product distinguished (or not) from the creation and maintenance of the benchmark itself?

# Self-Help Is All We Have Now

## Protecting Investors in the United States

- Who will maintain the benchmark over time (be the administrator)?
- What are the financial incentives for the benchmark administrator?
- Is the benchmark administered and/or calculated by an entity independent from those that sell or trade in instruments that are priced against the benchmark?
  - If not, are there legal or institutional separations from the benchmark administration and calculation functions versus the sales or trading functions? Are these separations independently reviewed and audited?
- Does the benchmark administrator have appropriate expertise, resources, compliance, and oversight functions to ensure quality and integrity?
- Does the administrator have other financial interests that may run counter to the investor in the benchmark-linked investment product?
- Is the benchmark administrator trading around my exposure in ways that could impact the benchmark? If so, how?
- Does the benchmark administrator or calculation agent have a compliance program designed to ensure the integrity of the benchmark?
  - If so, does the compliance function have a reporting line independent from units that would benefit from selling or trading in the benchmark? Is this compliance function and the administration or calculation of the benchmark subject to independent oversight by a regulator or subjected to regular external audits?

# Thank you!



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# About Healthy Markets Association

## Launched in 2015

- Mission: Inform and empower investors on trading markets

## Key Organization Initiatives

- Order Routing Integrity
- ATS/Trading Venue Integrity
- Best Execution and Research Cost Transparency
- Benchmark Integrity
- Market Data Accessibility

## Membership

- **Pensions:** CalPERS, Colorado PERA, OMERS, PSP
- **Advisers:** Brandes Inv. Ptnrs, Macquarie Inv. Mgmt, Quantitative Inv. Mgmt, Sands Capital
- **Working Group:** Brokers (Clearpool and Dash Financial), Exchanges (IEX and MIAX), and Data Vendors (Bloomberg, IHS Markit, and Maystreet).

## Information

- Weekly updates
- Monthly *Market Structure Insights* reports
- Monthly calls
- Issue-specific research and reports
- Annual *Healthy Market Structure Conference*
- Regular access to third-party experts

## Technical Assistance

- Due diligence questionnaires (order routing and ATSS)
- Operational and compliance support

## Engagement

- Regular communications with policymakers and regulators in the US and EU, including meetings, comment letters, etc.
- Coordination with associations and groups