HEALTHY MARKETS ASSOCIATION
A MEMBER ORGANIZATION

CFA Institute

August 16, 2022

Via Electronic Mail (rule-comments@sec.gov)

Ms. Vanessa Countryman, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

RE: Request for Comment on Certain Information Providers Acting as Investment Advisers, File No. S7–18–22[1]

Dear Secretary Countryman,

In response to the Request for Comment, the Healthy Markets Association[2] and CFA Institute[3] write to urge the Commission to propose rules or guidance to enhance oversight of third parties that provide investment advisory services.

The RFC is an important step forward in recognizing the risks to investors and conflicts of interest that may be going unaddressed because many information providers, and index and model portfolio providers in particular, are often not currently treated as subject to an appropriately tailored regulatory regime.

Background

Index providers and model portfolio providers increasingly provide essential services to investment advisers and investment companies. These information providers assist with

[1] *Request for Comment on Certain Information Providers Acting as Investment Advisers*, SEC, 87 Fed. Reg. 37254, June 22, 2022, *available at* https://www.govinfo.gov/content/pkg/FR-2022-06-22/pdf/2022-13307.pdf ("Request for Comment" or "RFC").

[2] Healthy Markets Association ("HMA") engages asset owners, asset managers, brokers, exchanges, data providers, policymakers, regulators, and other stakeholders to increase capital markets transparency and reduce conflicts of interest, risks, and costs for investors. To learn about HMA or our members, please see our website at http://healthymarkets.org.

[3] CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion of ethical behavior in investment markets and a respected source of knowledge in the global financial community. Our aim is to create an environment where investors' interests come first, markets function at their best, and economies grow. There are more than 190,000 CFA® charterholders worldwide in more than 160 markets. CFA Institute has nine offices worldwide and there are 160 local societies. In the U.S., CFA Institute has more than 81,000 members in the US and 51 societies. For more information, visit www.cfainstitute.org or follow us on Linkedin and Twitter at @CFAInstitute.

investments in trillions of dollars in assets ranging from stocks to corporate bonds to commodities to digital assets to interest rates.

While many market participants and regulators have historically treated index-based investing as "passive," the provision of indexes is often far less passive than one might suspect.[4] Index providers often provide active decision-making in the creation and administration of an index. This may include determining which factors to consider, how the factors are collected, how the factors are assessed, and how they are modified over time. For example, index providers often have significant discretion in the application of their own methodologies, and may reconstitute or rebalance an index sometimes without any obligation to publicly disclose how they come to those decisions. These decisions may be subject to significant conflicts of interest.[5]

At the same time, many indexes are highly specialized to the selection criteria of a particular user. For example, many index providers allow users to create their own selection criteria for index constituents, and others go so far as to offer indexes built to the specific specifications of the client. Whether a particular index is specialized or not, the inclusion, exclusion, and weighting of a specific security can induce advisers and their clients tracking that particular index to buy or sell securities in direct response to the index provider's inclusion, exclusion, and weighting choices.

Model portfolio providers, or "model originators," develop groups of assets that are designed to meet particular performance and risk factors. In addition to models meant to pursue defined strategies like capital preservation or income generation, there has also been growth in specialized models that focus on particular industries or target ESG investments. Model portfolio providers typically earn revenue from fees on the securities held within the model, though some providers also charge fees for use of the portfolio itself. When an investment adviser uses these third-party models in their practice, it raises questions about the investment adviser's client's knowledge of where they are paying their fees and who owes them a fiduciary duty. The arrangement may also conceal potential conflicts of interest.

Experts increasingly suggest that index and model portfolio providers often exercise delegated management responsibilities,[6] which raises questions regarding whether index and model portfolio providers are advisers (or sub-advisers) to funds. However, while there have been increased public calls for regulation of index providers in the

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[4] See Tyler Gellasch and Andres Vinelli, Creating Protections for Index Investing, (Jan. 14, 2022), available at https://www.americanprogress.org/article/creating-protections-for-index-investing/.

[5] Kun Li, Xin (Kelly) Liu, and Shang-Jin Wei, *Is Stock Index Membership for Sale?*, National Bureau of Economic Research, (2021), *available at* http://www.nber.org/papers/w29365 (noting the possibilities for conflicts of interest when securities issuers attempt to influence index membership by purchasing services from index providers).

[6] *See, e.g.*, Adriana Z. Robertson, *Passive in Name Only: Delegated Management and "Index" Investing*, 36 Yale J. on Reg. 795 (2019), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3244991 (framing many index providers as "delegated management"); *see also, Benchmark-Linked Investments – Managing Risks and Conflicts of Interest*, HMA, at 3, Mar. 7, 2019, *available at* https://healthymarkets.wpengine.com/product/benchmark-linked-investments.

United States,[7] neither policymakers nor regulators have outlined how that oversight should be structured.

Legal Framework

Under the Investment Advisers Act of 1940, in general, an "investment adviser" is anyone who "for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities."[8] A third party can also contractually assume these responsibilities from another investment adviser (e.g., as a sub-adviser).

Similarly, the Investment Company Act of 1940 generally categorizes a person as an adviser to an investment company if:

1. The person regularly furnishes advice to the fund with respect to the desirability of investing in, purchasing or selling securities or other property, or is empowered to determine what securities or property should be purchased or sold by the fund; and

2. the person acts pursuant to a contract with the fund.[9]

Further, the Investment Company Act also would apply to a person who regularly performs substantially all the duties undertaken by such investment adviser to an investment company pursuant to a contract.[10]

However, there are several exclusions to the investment adviser regulatory regime, including the so-called "publisher's exclusion," which exempts "publisher(s) of any bona fide newspaper, news magazine or business or financial publication of general or regular circulation."[11] Another exemption applies to brokers whose services are "solely incidental" to their broker or dealer businesses and who receive "no special compensation" for those services.[12]

Request for Comment

The RFC highlights three classes of information providers that perform essential functions in the modern financial marketplace: index providers, model portfolio

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[7] *See, e.g.,* Robert J. Jackson, Jr. and Steven Davidoff Solomon, *What's Really in Your Index Fund?*, N.Y. Times, Feb. 18, 2019, *available at* https://www.nytimes.com/2019/02/18/opinion/index-fund.html.
[8] 15 USC § 80b-2(a)(11).
[9] *See* 15 U.S.C. 80a-2(a)(20)(A).
[10] *See* 15 U.S.C. 80a-2(a)(20)(B).
[11] 15 USC § 80b-2(a)(11).
[12] *Id.*

providers, and pricing services. The role of these providers has grown tremendously over the past several decades in both the number of such providers and the impact their services have on the shape of the markets.

In light of this growth and the rapid change and impact of new technologies, the RFC seeks input through forty enumerated questions that essentially boil down to one fundamental question:

> ***How should the Commission oversee information providers that likely meet the statutory definition of investment adviser, but are not currently regulated as such?***

Response and Recommendations

If an information provider has contractually assumed responsibilities that allocate investors' capital, then it should be regulated appropriately. Whereas registration as an investment adviser comes with disclosure and recordkeeping requirements, a fiduciary duty to clients, and limitations on the types and nature of compensation, no similarly comprehensive U.S. regulatory regime currently applies to index providers.

The Commission should adopt a regulatory framework that establishes clear standards for index governance, quality, methodology, and accountability (including disclosures for any associated fees and expenses).[13] Because index providers and model portfolio providers already may satisfy the statutory elements for registration as investment advisers, the Commission would be well within its statutory authority to adopt an appropriate regulatory regime.

However, because the Commission has thus far declined to assert its authority in this arena, the Commission should provide adequate notice to covered index and model portfolio providers of their status. Further, because the existing investment advisor regulatory regime was not tailored over the years with these specific entities in mind (i.e., entities that do not manage assets or trade securities), we recommend that the Commission adopt a narrowly tailored regulatory regime for these types of information providers.

Rather than applying the entirety of the obligations pursuant to registration under the Investment Advisers Act to all index and model portfolio providers, we recommend that the Commission consider adopting a safe harbor for those that are not broadly providing other investment advisory services or offering personalized advisory services to either individual investors or investment companies. Personalized investment advice might be defined as:

- creating or modifying an index upon licensee or potential licensee request, where the index does not comport with IOSCO principles, is provided by an affiliate of

[13] HMA Report, at 4.

the fund, or is offered directly by the index provider to an investment company or retail investor,

- providing a licensee, licensees, or potential licensee with preferential information access concerning the composition and maintenance of an index, or
- providing individualized advice or information about sampling procedures for tracking the index.

For those that qualify for the safe harbor, we recommend that the index or model portfolio provider meet regulatory obligations focused on fair governance, quality control, and accountability. Those standards should, to the extent possible, be consonant with the principles put forth by the International Organization of Securities Commission in 2013[14] and the European Union's Benchmarks Regulation,[15] which has been in effect since 2016 and is overseen by the European Securities and Markets Authority (ESMA).

As ESMA explains on its website:

> The Benchmarks Regulation aims at (i) improving the governance and controls over the benchmark process, in particular to ensure that administrators avoid conflicts of interest, or at least manage them adequately; (ii) improving the quality of input data and methodologies of benchmarks; (iii) ensuring that contributors to benchmarks and the data they provide are subject to adequate controls, in particular to avoid conflicts of interest; (iv) protecting consumers and investors through greater transparency and adequate rights of redress; and (v) ensuring that supervised entities have robust written plans in case of cessation or material changes of benchmarks.[16]

A similar regime in the United States for index providers is long overdue.

Further, while an index or model portfolio provider should meet the standards, there should be a complementary obligation imposed upon any adviser that seeks to rely upon such an index. Any registered investment adviser that constructs a fund (registered or not) on a licensed index or model portfolio should be required to undertake due diligence to ensure that the index or model portfolio being used similarly meets the principles.

This approach would reduce the risks to investors, while also building upon the advancements in Europe, which should significantly ease the potential new burdens on

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[14] *Principles for Financial Benchmarks Final Report*, The Board of IOSCO, FR07/13, July 2013, *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf.

[15] Benchmark Regulation (EU) 2016/1011, European Parliament and the Council, June 8, 2016, *available at* https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R1011&from=EN.

[16] *Benchmarks*, ESMA, *available at* https://www.esma.europa.eu/policy-rules/benchmarks (last visited, Aug. 4, 2022).

index and model portfolio providers. Many of the world's largest index providers and fund companies are already very familiar with this approach. It's time for the U.S. regulatory apparatus to catch up.

Conclusion

Thank you for your consideration. Should you have any questions or would like to discuss these matters further, please contact Tyler Gellasch at [redacted] or Andres Vinelli at [redacted].

Sincerely,

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Tyler Gellasch
Healthy Markets Association

Andres Vinelli
CFA Institute