



Americans for Financial Reform Education Fund

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Securities and Exchange Commission
100 F St NE
Washington, DC 20549

August 16, 2022

**Re: Request for Comment on Certain Information Providers Acting as Investment Advisers
(File No: S7-18-22)**

Secretary Countryman,

The Americans for Financial Reform Education Fund (AFREF) appreciates this opportunity to comment on the Securities and Exchange Commission's ("the Commission") proposal to treat index fund providers with the same regulations and protections afforded to investors under the Investment Advisers Act of 1940. AFREF supports this proposal as index fund providers engage in behavior similar to an investment adviser, such as actively selecting the constituents of its indices and in turn heavily influencing the investment behavior of other firms, and thus should be treated similarly.

Index funds operate in numerous ways similar to an investment adviser

As the Commission correctly recognizes, index providers operate in a number of ways that should subject them to regulation as investment advisers including:

1. Providing advice related to securities
2. Providing investment services
3. Receiving compensation for such services

Index providers, whose assets have doubled from \$10 trillion in 2016 to \$20 trillion in 2021,¹ have been credibly accused of several conflicts-of-interest,² and are overdue to be subject to supervision and regulation by the Commission.

¹ Wynne, Trilbe. Pensions & Investments. Passive assets rise 35.9% to \$20.87 trillion on strong returns. Nov 12, 2021. <https://www.pionline.com/special-report-index-managers/passive-assets-rise-359-2087-trillion-strong-returns>

² Amery, Paul. ETF.com. Index Business Rife With Conflicts Of Interest, Says EDHEC. Dec 19, 2012. <https://www.etf.com/sections/features-and-news/8740-index-business-rife-with-conflicts-of-interest-says-edhec-risk>

This view has been echoed by the former chief executive of one of the largest index providers - the S&P Dow Jones Indices - who has written that index providers are “one of the only segments of the capital markets not regulated in the US” and that “regulatory oversight is necessary”.³

Index funds are often mistakenly referred to as “passive investments,” but have proven to be quite active

Index providers, by the very act of specifically selecting an issuer for inclusion in their index from a broader eligible set, are in fact actively managing the fund and, by extension, providing investment advice to their investors.

In a study of 601 U.S. indices to which 3,206 mutual funds are benchmarked, not a single benchmark index had a portfolio that did not change, meaning that every index was at one point or another actively managed by the index provider rather than operating as a strictly buy-and-hold type strategy.⁴

Even in an index fund that exactly mimics a broadly referenced index such as the S&P 500, index constituents are constantly added and removed from the index at by an Index Committee.⁵

For example, on December 21, 2020, electric vehicle manufacturer Tesla was included in the S&P 500 while Apartment Investment Management was removed.⁶ As a result of that decision, several investment funds collectively had to sell about \$51 billion worth of other S&P 500 index constituents in their portfolios to rebalance their portfolios and purchase Tesla to mimic S&P’s Index Committee’s decision to include the electric vehicle manufacturer.⁷ Several investment funds at the time also faced a difficult decision at the time of whether to follow suit with the S&P Index Committee’s decision given concerns about the company’s corporate governance and the stock potentially being overpriced.⁸

³ Maturri, Alex. Financial Times. Index regulation is tricky but necessary. Jun 22, 2022.

<https://www.ft.com/content/894cc4d4-8811-48e1-a158-47a186a1075e>

⁴ Robertson, Adriana. University of Chicago Law School. Passive in Name Only: Delegated Management and “Index” Investing. Jul 18, 2019. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3244991

⁵ Weber, Joel and Balchunas, Eric. Bloomberg News. The Secretive Committee Behind the S&P 500. Oct 1, 2020.

<https://www.bloomberg.com/news/articles/2020-10-01/the-secretive-committee-behind-the-s-p-500>

⁶ Arnott, Rob et al. Research Affiliates. Revisiting Tesla’s Addition to the S&P 500: What’s the Cost, Before and After? June 2021. <https://www.researchaffiliates.com/publications/articles/832-revisiting-teslas-addition-to-the-sp500>

⁷ Randewich, Noel. Reuters. Tesla to join S&P 500, spark epic index fund trade. Nov 16, 2020.

<https://www.reuters.com/article/us-usa-stocks-tesla/tesla-to-join-sp-500-spark-epic-index-fund-trade-idUSKBN27W2YF>

⁸ Liu, Evie. Barron’s. Tesla Has Joined the S&P 500. That Could Be a Problem for Your Investments. Dec 18, 2020.

<https://www.barrons.com/articles/tesla-is-joining-the-s-p-500-why-this-could-be-a-problem-for-many-investors-51607640088>

Index providers effectively provide investment advice

The Commission further needs to treat index providers as investment advisers since their decisions effectively constitute investment advice for various market participants.

When Tesla was added to the S&P 500, many investment managers were compelled to purchase shares of Tesla, to ensure that their own portfolios were following the composition of the S&P 500, sending Tesla's shares significantly higher. As one market participant remarked "Active portfolio managers that are benchmarked to that index are going to have to look at Tesla and care about Tesla."⁹

The implicit investment recommendations made by index committees also have implications for investment managers' Environmental, Social, and Governance (ESG) decisions.

Another popular index operated by S&P Global, the S&P 500 ESG index, has actively made several key distinctions about what investments qualify. For example, S&P excludes companies that are involved in landmines or biological and nuclear weapons along with tobacco companies, thermal coal companies, and small arms manufacturers from this index.¹⁰

On the other hand, S&P does include one of the largest oil and gas companies ExxonMobil who is one of the ten largest constituents in the index.¹¹

This also comes as other criteria is ESG investing such as corporate political activity still gets little-to-no consideration. ExxonMobil has been given a D- by organizations who closely follow political spending such as PoliticalMap for continuing to lobby behind-the-scenes in contrast to its public statements for fossil fuel development and maintaining an extensive network of industry associations opposing climate policies globally.¹²

Investment managers operating ESG funds benchmarked to the S&P 500 ESG Index, and whose personal performance will be closely compared to it, may as a result feel compelled to invest in oil and gas companies such as ExxonMobil against their own personal views on what constitutes ESG.¹³

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¹⁰ S&P Down Jones Indices. S&P 500 ESG Exclusions II Index. <https://www.spglobal.com/spdji/en/indices/esg/sp-500-esg-exclusions-ii-index/#overview>

¹¹ Crider, Johnna. CleanTechnica. In A Parallel Universe, Oil Companies Included in S&P 500 ESG Index While Tesla Kicked Out...Oh, Wait. May 21, 2022. <https://cleantechnica.com/2022/05/21/in-a-parallel-universe-oil-companies-included-in-sp-500-esg-index-while-tesla-kicked-out-oh-wait/>

¹² InfluenceMap. ExxonMobil. <https://lobbymax.org/company/Exxon-Mobil>

¹³ Hallez, Emile. Variability in ESG ratings makes a murky picture for investors. Jun 1, 2022.

<https://www.investmentnews.com/variability-in-esg-ratings-makes-a-murky-picture-for-investors-222210>

The opaque nature of Index Committees, and the fact that they sometimes do not follow their own criteria underline the need for oversight and regulation to prevent conflicts of interest. raise additional questions.

Fully one third of the S&P Index Committee's inclusions between 2015 and 2018 failed to meet at least one of the index provider's published criteria, despite the fact that hundreds of other alternative candidates did meet all of the criteria. Interestingly, a retroactive look at the issuers added found that they tended to perform worse than the potential alternatives.¹⁴

A recent academic study titled "Is Stock Membership for Sale?" in fact found a statistically significant link between issuers being included in S&P indices if they are also additionally paying for credit ratings from S&P as part of a bond offering.¹⁵ The researchers also further found that the likelihood of inclusion in a S&P index did not improve when a bond offering was rated by Moody's, further bolstering their findings that this issue is not driven by industry-wide dynamics but rather firm-specific.

Indexing is an incredibly lucrative business line for providers but is fraught with conflicts-of-interest that need to be regulated

The Investment Advisers Act considers anyone providing investment advisory services to be an investment adviser if they are receiving compensation for such services. Index divisions certainly meet that criteria; they have become incredibly lucrative businesses.

Index providers such as the S&P Dow Jones Indices, MSCI, FTSE generated a record \$5 billion in fees in 2021.¹⁶ This total does not include fees to other large index providers such as Russell Investments and Bloomberg which are privately owned.

The index provider industry is also heavily concentrated, and this gives them significant pricing power.

That's because, unlike traditionally managed funds, index providers don't just make money from the assets in their index but also from an assortment of other fees fund managers have "little choice but to pay" including for licensing.¹⁷ Of the \$5 billion in index revenues, more than half (\$2.6 billion) came from licensing fees.¹⁸

¹⁴ Megaw, Nicholas and Stafford, Philip. Financial Times. Academics cast harsh light on composition of S&P index. Oct 15, 2021. <https://www.ft.com/content/e30a3667-258f-4e13-bc15-7768f4055f26>

¹⁵ Li, Kun and Liu, Xin and Wei, Shang-Jin. National Bureau of Economic Research. Is Stock Index Membership For Sale? November 2021. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3940053

¹⁶ Swink, Sonya. Financial Times Ignites. Index providers take record \$5 billion in revenue in 2021. May 24, 2022. <https://www.ft.com/content/595c3c18-7c13-4e33-9a68-f82f558b7ad6>

¹⁷ Segal, Julie. Institutional Investor. Morningstar: It's Time to Disrupt Index Providers. Dec 6, 2019.

<https://www.institutionalinvestor.com/article/b1jbswm1y1rkqw/Morningstar-It-s-Time-to-Disrupt-Index-Providers>

¹⁸ Id. at 12.

Treating index providers as advisers is critical to accomplishing the Commission's goal of stopping greenwashing

We applaud the actions the Commission is taking to stop greenwashing and other types of exaggerated or unfounded ESG-related claims. One such action has been to propose the rule entitled “Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, And Governance Investment Practices,” which AFREF is also commenting on.

The proposal, if implemented, would require certain ESG-designated funds (ESG-focused funds, as defined by the Commission’s proposal) that track an ESG-related index to “describe the index and how the index utilizes ESG factors.” However, the proposal does not include a requirement to make disclosures about the ESG strategies of the index the fund tracks. Therefore, if index providers are not treated as advisers, investors would have limited information about the ESG strategies underlying the indices their funds track, leaving them exposed to greenwashing and other types of ESG-washing. This would result in a significant regulatory gap, as ESG indices rose globally by 40.2% between 2019 and 2020,¹⁹ and according to Morningstar, the number of—and money invested in—sustainable mutual funds and exchange-traded funds has more than doubled in the last three years.²⁰

Conclusion

We appreciate the work the Commission is doing to address issues with index providers, and strongly support the Commission’s proposal to regulate them under the Investment Advisers Act.

Upon adoption of a final rule, we urge the Commission to consider further rulemaking to address additional problems that can arise with index providers, such as ensuring their data is both accurate and timely for both the investors invested in the indices as well as for the fund managers who closely benchmarked to them.

We thank you for your consideration of this letter. For additional questions please contact Andrew Park at [REDACTED].

Sincerely,

Americans for Financial Reform Education Fund

¹⁹ Index Industry Association, Fourth Annual IIA Benchmark Survey Reveals Significant Growth in ESG Amid Continued Multi-Asset Innovation & Heightened Competition. Oct. 28, 2020. <https://www.businesswire.com/news/home/20201028005255/en/Index-Industry%E2%80%99s-FourthAnnual-Benchmark-Survey-Reveals-Significant-Growth-in-ESG-Amid-Continued-Multi-AssetInnovation-Heightened-Competition>

²⁰ Benson, Alana. NerdWallet. Best ESG Funds: High-Rated and Low-Cost Options. Jun. 16, 2022. <https://www.nerdwallet.com/article/investing/best-esg-funds>

