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Benchmarking the World: A Proposal for Regulatory Oversight of Stock Market Index Providers

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ABSTRACT

Wall Street has recently seen a shift from active management, which involves investors or portfolio managers buying and selling stocks, towards passive management, where investors invest in funds that seek to match the returns of an underlying index. As the popularity of index funds has grown, questions have arisen regarding the role of the index providers that produce the underlying indices. Unlike the funds themselves, these providers are largely unregulated, and have considerable discretion to determine the makeup of indices. This wide discretion allows index providers to exercise control over the global investment community since they have the ability to control investors' exposure to different countries' markets. The role of index providers also raises concerns about investor transparency and market manipulation in the wake of the 2012 LIBOR manipulation scandal. Recently, efforts have been made to create regulatory frameworks within Europe and on an international scale. This Note argues that the US investment industry should require index providers to register with the Securities and Exchange Commission and to solicit comments from the public through notice-and-comment periods when the providers add new rules or modify existing rules.

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I. INTRODUCTION

When thinking about how to be successful in the stock market, a familiar image often comes to mind: that of the sharp-minded investor who has managed to profit immensely in ways that may seem mysterious and unattainable to the average person.[1] After all, if it were that easy, wouldn't everyone make millions from playing the markets? Perhaps it is unsurprising then that potential investors, whether they are chasing a windfall or simply looking to retire with a comfortable nest egg, often choose "actively managed" funds, or funds that use a manager, or group of managers, in the hopes of beating the market.[2] However, in recent years, Wall Street has witnessed a shift towards a more hands-off, "everyman" approach, known as "passive investing" or "passive management."[3] In contrast to actively managed

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1. *See* Dennis K. Berman & Jamie Heller, *Wall Street's "Do-Nothing" Investing Revolution*, WALL ST. J. (Oct. 17, 2016, 10:30 AM), http://graphics.wsj.com/passivists/ [https://perma.cc/6HTC-F8KB] (archived Aug. 18, 2018) ("Picking stocks is at heart an arrogant act. It requires in the stock picker a confidence that most others are dunces, and that riches await those with better information and sharper instincts."). American culture in particular often venerates investing magnates. *See, e.g.*, Aline Sullivan, *Buffett, the Sage of Omaha, Makes Value Investing Seem Simple: Secrets of a High Plains Investor*, N.Y. TIMES (Dec. 20, 1997), https://www.nytimes.com/1997/12/20/your-money/IHT-buffett-the-sage-of-omaha-makes-value-strategy-seem-simple.html [https://perma.cc/TCS6-FVCJ] (archived Aug. 18, 2018) ("The so-called sage of Omaha has none of the glamour of John F. Kennedy or Marilyn Monroe, but for millions of investors he embodies the American Dream."); Gregory Zuckerman, *A Bearish George Soros is Trading Again*, WALL ST. J. (June 9, 2016, 5:56 PM), https://www.wsj.com/articles/a-bearish-george-soros-is-trading-again-1465429163 [https://perma.cc/QQR6-SL9U] (archived Aug. 18, 2018).

2. *Active Management*, INVESTOPEDIA, http://www.investopedia.com/terms/a/activemanagement.asp (last visited Sept. 3, 2018) [https://perma.cc/9XUQ-2ND3] (archived Aug. 18, 2018).

3. *See* Berman & Heller, *supra* note 1 ("[T]he idea of the 'active manager' is rapidly losing its intellectual legitimacy to the primacy of the 'passive investor' who merely buys an index of shares."); Myles Udland, *One chart that is sure to give Wall Street nightmares*, BUS. INSIDER (Aug. 19, 2016, 3:20 PM), http://www.businessinsider.com/rise-of-passive-investing-2016-8 [https://perma.cc/28YU-KRB6] (archived Aug. 18, 2018). Generally speaking, the term "passive investing" refers to the overall strategy of maximizing returns over the long run by keeping the amount of buying and selling to a minimum, and therefore reducing transaction fees and costs. The most common way to achieve this strategy is by purchasing shares of an "index fund" that tracks the stock market index of an investor's choosing. *See Passive Management*, INVESTOPEDIA,

investments, which involve purchasing individual stocks or bonds, passive investment funds, or "index funds," track stock market indices—such as the Standard & Poor's 500 Index (S&P 500)—with the goal to match the index's returns.[4]

Unlike their actively managed counterparts, passively managed index funds do not use portfolio managers and do not involve any complicated research on the part of an investor; instead, the index fund tracks a stock market index with the intent to match its performance.[5] Since they do not require portfolio managers, index funds often cost much less than actively managed funds.[6] Although there are conflicting opinions, many studies have also suggested that index funds may actually perform better than their actively managed counterparts.[7] Regardless of whether this is true, index funds are highly attractive to investors and continue to rise in popularity.[8]

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http://www.investopedia.com/terms/p/passivemanagement.asp [https://perma.cc/XXL4-5B6D] (archived Aug. 18, 2018); Charles Stein, *Active vs. Passive Investing*, BLOOMBERG QUICKTAKE (Dec. 4, 2017, 2:55 PM), https://www.bloomberg.com/quicktake/active-vs-passive-investing [https://perma.cc/VS5Z-Z5H4] (archived Aug. 18, 2018).

4. A stock market index represents an aggregate value that is produced by combining several stocks or other investment vehicles together and expressing their total values against a base value from a specific date. The result can then be used as a benchmark for investors. *Market Index*, INVESTOPEDIA, http://www.investopedia.com/terms/m/marketindex.asp (last visited Sept. 3, 2018) [https://perma.cc/3HXR-7MXN] (archived Aug. 21, 2018).

5. An "index" may refer to public indices such as the Wholesale Price Index (WPI) and gross domestic product (GDP); product index providers, which create stock market indices as their primary business; and byproduct index providers, which produce indices as an incident to some other profit-making activity. This Note focuses on the second category of product index providers (hereinafter referred to as "index providers") and their role in the financial industry. *See* Gabriel Rauterberg & Andrew Verstein, *Index Theory: The Law, Promise and Failure of Financial Indices,* 30 YALE J. ON REG. 1, 25 (2013). For more background on stock market indices, see, for example, Norm Alster, *The Ease of Index Funds Comes with Risk,* N.Y. TIMES (Oct. 11, 2015), https://www.nytimes.com/2015/10/11/business/mutfund/the-ease-of-index-funds-comes-with-risk.html [https://perma.cc/NP7U-G46G] (archived Aug. 18, 2018); Anne Tergesen & Jason Zweig, *The Dying Business of Picking Stocks,* WALL ST. J. (Oct. 17, 2016, 12:12 PM), https://www.wsj.com/articles/the-dying-business-of-picking-stocks-1476714749 [https://perma.cc/G9CL-7FN6] (archived Aug. 18, 2018).

6. *See* Alster, *supra* note 5.

7. For example, Burton Malkiel notes that a "remarkably large" body of evidence suggests that professional investment managers are not able to outperform index funds. Burton G. Malkiel, *The Efficient Market Hypothesis and its Critics,* 17 J. ECON. PERSP. 59, 77 (2003) [hereinafter *Efficient Market Hypothesis*]. *See also* Tom Anderson, *Index funds trounce actively managed funds: Study,* CNBC (June 26, 2015, 12:43 PM), https://www.cnbc.com/2015/06/26/index-funds-trounce-actively-managed-funds-study.html [https://perma.cc/77E4-HSSL] (archived Aug. 18, 2018); Jonnelle Marte, *Active vs. Passive: How fund managers stack up to index funds,* THE WASH. POST (June 29, 2015), https://www.washingtonpost.com/news/get-there/wp/2015/06/29/active-vs-passive-how-fund-managers-stack-up-to-index-funds/ [https://perma.cc/2Q3W-S8DQ] (archive Aug. 18, 2018). *But see Is There a Case for Actively Managed Funds?*, WALL ST. J. (Mar. 1, 2015, 11:37 PM), https://www.wsj.com/articles/are-index-funds-really-better-than-actively-managed-

The rise of passive investments and index funds may seem like a win for investors at first glance. However, increased reliance on passive investments raises questions about regulatory oversight for the underlying stock market indices. Active and passive management strategies are often framed in terms of "beating the market" and "matching the market," respectively.[9] However, how "the market" is defined depends on which index the fund chooses since index funds track individual indices that track different subsets of the market.[10] In contrast to investment funds, which are subject to oversight by regulatory bodies in some capacity, stock market indices are compiled by index providers, which are third parties that use their own proprietary research to produce stock market indices, and are often unregulated.[11] Index providers choose internal committees that determine which companies or countries will make up a stock market index, and the companies that are included in a stock market index

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1425271058 [https://perma.cc/Q7QJ-R648] (archived Aug. 18, 2018) (noting that there are some actively managed funds that beat the returns of passive index funds).

8. *See, e.g.*, Ryan Vlastelica, *Passive investing, a winner in 2016, shows no sign of stopping*, MARKETWATCH (Dec. 31, 2016, 2:38 PM), https://www.marketwatch.com/story/passive-investing-a-winner-in-2016-shows-no-sign-of-stopping-2016-12-27 (last visited Aug. 21, 2018) ("One of the biggest investment trends of the past decade continued unabated this past year, as investors rotated out of active investments—where the components are chosen by an individual or team rather than being pegged to a benchmark—to passive-based ones . . . . While more assets continue to be held in active strategies than passive—$9.3 trillion versus $5.3 trillion, according to Morningstar—the shift is clear, and the reasons behind it are simple: Not only are passive-based strategies typically cheaper than active ones . . . they've historically boasted greater performance.").

9. *See, e.g.*, Spencer Jakab, *Are Fund Managers Doomed? Making the Case for Passive Investing's Triumph*, WALL ST. J. (Oct. 18, 2016, 10:13 AM), https://www.wsj.com/articles/are-fund-managers-doomed-making-the-case-for-passive-investings-triumph-1476798977 [https://perma.cc/7LN6-ZVXU] (archived Aug. 18, 2018); Mitch Tuchman, *What is an Index Fund? Investing Basics*, FORBES (July 12, 2013, 3:08 PM), https://www.forbes.com/sites/mitchelltuchman/2013/07/12/what-is-an-index-fund-investing-basics/ [https://perma.cc/K7T7-W6RZ] (archived Aug. 21, 2018).

10. *See* Jakab, *supra* note 9.

11. *See About the Office*, DIV. OF INV. MGMT., U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/investment [https://perma.cc/T22U-FREW] (archived Aug. 21, 2018). *See generally* BRYAN CHEGWIDDEN ET AL., ROPES & GRAY LLP, INVESTMENT FUNDS IN UNITED STATES: REGULATORY OVERVIEW (2013) (providing an overview of the regulatory frameworks governing different types of investment funds). For instance, the United States Securities and Exchange Commission (SEC) does not regulate the content of stock market indices. *See Market Indices*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/fast-answers/answersindiceshtm.html (last visited Sept. 3, 2018) [https://perma.cc/QPK5-7RB3] (archived Aug. 21, 2018). Index research is often framed in terms of a product to be sold to investment managers. For instance, MSCI notes that it has remained a "market leader by expanding and enhancing its index offering to reflect the evolving and complex needs of the institutional investment community with ground breaking new products, innovative research, high quality data and dedicated client support." GLOBAL INDEXES, MSCI (2017), https://www.msci.com/documents/12961 02/0/GlobalIndexes-cbr-en+FINAL.PDF/68efcb48-94f2-4d63-964c-c6cb07a51670 [https://perma.cc/NU5A-2Y5R] (archived Aug. 21, 2018).

may change at any time depending on that committee's decisions.[12] Although this may seem analogous to portfolio managers protecting their investment strategies, portfolio managers are subject to fairly rigorous disclosure requirements due to their involvement with investment managers, which are organizations that make investments in portfolios of securities on behalf of clients in accordance with investment objectives and parameters determined by those clients.[13] This Note argues that this lack of regulatory oversight for index providers is problematic, given their growing role in the overall American economy and potential to affect markets on a global scale.

This Note explores the risks and outcomes related to the current lack of regulatory oversight for market indices and argues that a regulatory framework is necessary to address issues such as investor transparency, market manipulation, and effects on countries' economies resulting from country reclassification decisions. Part II provides a broad overview of stock market indices and differences between active and passive management strategies. Part III compares index methodology for three of the leading index providers: S&P Dow Jones (Dow Jones), MSCI Inc. (MSCI), and FTSE Group (FTSE).[14] Each of these index providers creates their own indices based on independent research and uses proprietary models to classify countries' economies into different categories for inclusion in indices.[15]

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12. Rauterberg and Verstein note that while the S&P 500 is meant to track the most significant large-capitalization firms in the leading U.S. industries, S&P 500 component companies are not the largest five hundred companies on the New York Stock Exchange. Rauterberg & Verstein, *supra* note 5, at 18–19. Further, a committee chooses the companies that are included in the S&P 500, using additional filters that are subject to human discretion; the committee also decides the index's selection frequency. *Id.*

13. *Investment Manager*, INVESTOPEDIA, https://www.investopedia.com/terms/i/investment-manager.asp (last visited Sept. 3, 2018) [https://perma.cc/Z7PF-PXGU] (archived Aug. 21, 2018). Investment managers and the portfolio managers that they employ are subject to rigorous disclosure requirements by the SEC. *See* 17 C.F.R. §§ 239, 249, 270, 274 (2004).

14. *See* Tracy Alloway, Dani Burger & Rachel Evans, *Index Providers Rule the World—For Now, at Least*, BLOOMBERG (Nov. 26, 2017, 6:00 PM), https://www.bloomberg.com/news/articles/2017-11-27/index-providers-rule-the-world-for-now-at-least [https://perma.cc/X3G6-TFR7] (archived Aug. 21, 2018) (describing the "growing clout" of these index providers). Although there are many other index providers, this Note will focus on Dow Jones, MSCI, and FTSE for brevity's sake.

15. The Dow Jones Industrial Average and the S&P 500 Index are two of the most common indices in the United States. *See Market Indices*, *supra* note 11; *see also* Rauterberg & Verstein, *supra* note 5, at 4–5 ("The S&P 500 is the leading indicator of the state of the U.S. economy and the stock market's daily returns, with well over $1 trillion of investments tied to it alone . . . . Everywhere we rely on indices to aggregate information, guide our investments, and settle our contracts."). However, there are many other stock market indices, including indices that track stock exchanges in other

Part IV builds on the explanation of each index provider's methodology in order to analyze the benefits and risks of using index providers that engage in independent research to create indices. Part IV begins by discussing the dangers of the lack of transparency for investors that results from a lack of regulatory framework. It then discusses the potential for market manipulation, analogizing to the recent London Interbank Offered Rate (LIBOR) manipulation scandal. LIBOR differs slightly from indices discussed in this Note since it is not a standalone product, but is maintained by banks to serve as a benchmark for their products.[16] However, the LIBOR scandal provides an important case study for market index providers. Part IV concludes by discussing potential effects on countries' economies, both broadly and with respect to Saudi Arabia, which was recently included in emerging market indices.[17]

Part V proposes that index providers' strategies should be subject to greater financial regulation in the United States, which will hopefully lead to greater transparency and uniformity. In doing so, this Note looks to the current regulatory frameworks in place, which include both the European Union's (EU) recent Benchmark Regulation proposal and the 2013 IOSCO Principles for Financial Benchmarks.[18] In lieu of a formal rule or regulation, this Note proposes that index providers register with the U.S. Securities and Exchange Commission (SEC) and engage in formal notice-and-

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countries (such as the Hang Seng Index, which tracks the Hong Kong stock exchange), indices that track groups of countries (which often break the groups down into categories like "emerging" or "developing" markets) and indices that track groups of companies within certain industries (such as technology or healthcare). This Note will focus on the classification of countries into different groups based on their economy type. *See, e.g.*, GLOBAL INDEXES, *supra* note 11; *Stock Market Indices*, NASDAQ, http://www.nasdaq.com/markets/indices/ (last visited Aug. 21, 2018) [https://perma.cc/77FP-LNH6] (archived Oct. 5, 2018).

16. *See* Richard Pullin, *Traders fired, suspended over LIBOR probe*, REUTERS (Feb. 8, 2012, 8:33 PM), https://www.reuters.com/article/us-investigation-interbank-lending/traders-fired-suspended-over-libor-probe-ft-idUSTRE81807L20120209 [https://perma.cc/YH96-9BNY] (archived Aug. 21, 2018) (describing regulators' investigation of banks that help set Libor "to determine whether [they] colluded to set overnight rates during the global financial crisis, and whether traders and their clients used the information to place profitable trades"); Rauterberg & Verstein, *supra* note 5, at 4 ("Few realize that Libor is published by a consortium of Libor's biggest users, the British Bankers' Association. It uses banks' proprietary data and is highly discretionary due to its reliance on subjective judgment.").

17. *See* Press Release, FTSE Russell, FTSE Russell Launches Comprehensive Saudi Arabia Inclusion Index Series (Oct. 29, 2017), http://www.ftserussell.com/sites/default/files/ftse-russell-saudi-arabia-final.pdf [https://perma.cc/929Y-YA6B] (archived Aug. 21, 2018) [hereinafter Press Release, Saudi Arabia Inclusion] (announcing a new series of indexes designed to support investors in the newly opened capital market of Saudi Arabia).

18. INT'L ORG. SEC. COMM'NS, PRINCIPLES FOR FINANCIAL BENCHMARKS 7 (2013), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf [https://perma.cc/9ZAEPZTX] (archived Aug. 21, 2018) [hereinafter IOSCO PRINCIPLES]; *Benchmarks*, EUROPEAN SEC. & MKTS. AUTH., https://www.esma.europa.eu/policy-rules/benchmarks [https://perma.cc/B5PG-FG93] (archived Aug. 21, 2018).

comment periods whenever they add new rules or modify existing rules.

II. THE RISE OF PASSIVE INVESTING AND THE IMPORTANCE OF STOCK MARKET INDICES

Annual reports have warned that it is "time to acknowledge the truth" that investors have shifted towards passive management.[19] The *Wall Street Journal* devoted a series of articles to the "do-nothing" investing revolution.[20] Even a cursory search online reveals headlines with ominous titles suggesting that portfolio managers are doomed to fail in the wake of passive investing's rise.[21] Regardless of what news outlets decide to name it, a change is certainly taking place within the investment industry, with the ongoing debate focusing on the rise of passive management and decline of active management.[22] Investors' shifts towards passive investment and their decisions to invest in passively managed index funds necessarily implicate the role of index providers that determine the composition of market indices.[23] This Part provides an overview of active and passive management. It then discusses the rise of index funds in greater detail and concludes by discussing how an "index" is defined.

A. *Overview of Active and Passive Management*

Roughly 66 percent of mutual fund and exchange-traded fund assets are currently actively managed, according to Morningstar, Inc., a leading investment research firm.[24] While this may seem like a large number, it is down from 84 percent ten years ago, and the number continues to decline.[25] Active management refers to the process of actively buying and selling individual stocks or bonds, either by individual investors or, more commonly, by portfolio managers that work for investment management firms.[26] Investors

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19. *See, e.g.*, COHEN & STEERS, 2015 ANNUAL REPORT 2, https://www.cohenandsteers.com/assets/content/press_releases/2015_CNS_Annual_Report-FINAL.pdf [https://perma.cc/2ZBJ-UE73] (archived Aug. 22, 2018).

20. Berman & Heller, *supra* note 1.

21. *See, e.g.*, Joe Rennison & Robin Wigglesworth, *No End in Sight for Passive Boom, Says Investing Pioneer*, FIN. TIMES (Nov. 14, 2017), https://www.ft.com/content/f605a2b4-c918-11e7-aa33-c63fdc9b8c6c [https://perma.cc/AA6M-KKAX] (archived Aug. 22, 2018); Vlastelica, *supra* note 8.

22. *See, e.g.*, Rennison & Wigglesworth, *supra* note 21; Vlastelica, *supra* note 8.

23. *See* Alloway, Burger & Evans, *supra* note 14.

24. *See* Jakab, *supra* note 9; *see also Home Page*, MORNINGSTAR, https://www.morningstar.com [https://perma.cc/PR3R-WNXD] (archived Aug. 22, 2018).

25. Jakab, *supra* note 9.

26. David Robinson, *Active or passive management: Why not take both approaches?*, CNBC (last updated Feb. 22, 2017, 8:53 AM), https://www.cnbc.com/2017/

or portfolio managers seek to "beat the market" through purchasing and selling different combinations of stocks or bonds.[27] Active investing is as old as the stock market itself: as Charles Stein notes, active investing is what used to just be called "investing."[28]

There are many legitimate reasons why an investor might choose to hire a professional to make investment decisions for them other than the fact that active investment management has traditionally dominated the investment industry. Active management allows for greater flexibility, since a portfolio manager can buy and sell stocks whenever they choose, and strategies can easily be tailored to an investor's desired levels of risk, profitability, and liquidity.[29] In contrast, an index fund requires an investor to purchase *all* of the underlying stocks on the index.[30] This can lead to problems with liquidity—whether a security is easy to price and can be bought or sold without changing its price significantly.[31] Andy Martin provides a helpful overview of this concept in an article for *Advisor Perspectives*, warning that the growth of passive investments will lead to lower levels of liquidity in general, not just for individual investors:

> A way to visualize this is by comparing traders for active and passive funds. The active manager, knowing that he wishes to accumulate a stock, checks the price, the high and low for the day, its volume of shares traded, the ex-dividend date, any market news and a variety of other indicators to get a sense of how much market impact his trade could make. He then purchases. In contrast, the index fund or ETF manager has a mandate and must purchase or sell indiscriminately shares in the percentage of their proportion to the underlying index. Though an index manager can stage purchases over time, what he buys or sells, and at what amounts, is fixed, like a bullet train speeding down a light-rail track. This monolithic force will only grow with the proliferation of indexed investing.[32]

In addition to the potential for greater liquidity, active management also offers the chance for greater returns: since a passively managed index fund will always track its underlying index, its investors will simply match its returns, and because investors pay a fee, the result is that the index fund will always slightly

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02/21/active-or-passive-management-why-not-take-both-approaches.html [https://perma.cc/XGJ9-E8FV] (archived Aug. 22, 2018).

27. Stein, *supra* note 3; *see also* Berman & Heller, *supra* note 1.

28. *See* Stein, *supra* note 3.

29. Robinson, *supra* note 26.

30. Tergesen & Zweig, *supra* note 5 (suggesting that passive index funds "run on autopilot by tracking an index").

31. *Definition of Liquidity*, FIN. TIMES LEXICON, http://lexicon.ft.com/Term?term=liquidity (last visited Sept. 3, 2018) [https://perma.cc/UX3R-U5QM] (archived Aug. 22, 2018).

32. Andy Martin, *The Rise of Passive and Indexed Investing, and its Effect on Market Perspectives*, ADVISOR PERSPECTIVES (Feb. 27, 2017), https://www.advisorperspectives.com/articles/2017/02/27/the-rise-of-passive-and-indexed-investing-and-its-effect-on-market-and-liquidity-risk [https://perma.cc/E8S5-R4UK] (archived Aug. 22, 2018).

underperform the underlying index.[33] In contrast, an actively managed fund can reap higher returns, though at the expense of a higher fee.[34] Regardless, active management strategies can be particularly useful for investors that want to use higher-risk investing strategies or are interested in investing in emerging markets or new technologies.[35] Having the trained eye of a portfolio manager can help investors spot "diamonds in the rough."[36] Conversely, an investor that is looking to invest in easily traded or popular companies may not gain any extra advantage by hiring a portfolio manager since information about those companies is often already well known.[37]

Finally, actively managed funds also provide tax efficiency for investors. Most investors that choose to invest in index funds do so through 401(k) plans or individual retirement accounts, but investors that keep stocks in taxable accounts can then harvest capital losses for tax deductions that offset capital gains.[38]

Despite the positive attributes and long-standing popularity of active investments, many investors still choose passive investment funds. Perhaps the most obvious reason for this is that passive investment funds are markedly cheaper: unlike portfolio managers, purveyors of passive investment funds have no need to protect their

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33. Robinson, *supra* note 26 ("Passive funds are built to track indexes or groups of stocks rather than to outperform them. So the index itself will always be underperformed by the amount of the expenses of the fund, however low.").

34. *See* Tergesen & Zweig, *supra* note 5.

35. *Active vs. Passive Investing: Which Approach Offers Better Returns?*, THE WHARTON SCHOOL, UNIV. PENN., https://executiveeducation.wharton.upenn.edu/thought-leadership/wharton-wealth-management-initiative/wmi-thought-leadership/active-vs-passive-investing-which-approach-offers-better-returns (last visited Sept. 3, 2018) [https://perma.cc/P926-DD4L] (archived Aug. 22, 2018).

36. *Id.*

37. *Id.*

38. *See* Robinson, *supra* note 26. Capital gains are defined as profits from the sale of a capital asset. The Internal Revenue Code § 1221 defines "capital asset" as property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business; property or real property, used in his trade or business. *See* I.R.C. § 1221 (1986). Short-term capital gains are taxed at the same rate as ordinary income, while long-term capital gains (those held for more than a year) are taxed at lower rates. *See How Are Capital Gains Taxed?*, *in* BRIEFING BOOK, TAX POLICY CTR., http://www.taxpolicycenter.org/briefing-book/how-are-capital-gains-taxed (last visited Sept. 3, 2018) [https://perma.cc/42JD-JJ2Q] (archived Aug. 22, 2018). In contrast, when investors withdraw from 401(k) plans, they must pay ordinary income taxes, regardless of whether the money came from contributions, dividends, or capital gains. *See Ultimate guide to retirement,* CNN MONEY, http://money.cnn.com/retirement/guide/401k_basics.moneymag/index7.htm (last visited Sept. 3, 2018) [https://perma.cc/E2RK-7XWE] (archived Aug. 22, 2018).

proprietary investment strategies, because the funds track underlying indices that are publicly available.[39] The lack of a special strategy leads to lower fees for the investor.[40] The overhead costs for an actively managed fund are obviously greater: active managers pay for research, pay more for trading, and must hire prestigious traders, analysts, and portfolio managers to make their trades.[41] Additionally, many investors may not have the time, money, or desire to either hire a portfolio manager or develop an investment strategy on their own.[42] Buying and selling stocks forces investors to "keep up with markets, sectors and companies; know how to read a balance sheet; and possess the skills needed to evaluate management teams, companies' market positions and the durability of their investable propositions."[43] Investors may also prefer to take advantage of a retirement plan offered through their employer, rather than maintain their own taxable account and manage their own portfolio, especially since many companies have policies that match an individual's contribution to their retirement accounts.[44] With the number of index funds in existence today, an investor has no shortage of choices when it comes to passive investment strategies, which has led some to question why an investor should spend the time researching individual securities, and run the risk of choosing the wrong stock in the wrong sector, when one can simply "buy the market as a whole."[45] As a result of the trend toward passive investing, investment management firms, including those that have traditionally specialized in active offerings, have increased their passive investment offerings, leading to growth in the number of passive investment funds currently on the market.[46]

Scholars have also challenged the performance of actively managed funds in comparison to their passively managed counterparts. Most notably, in *A Random Walk Down Wall Street,* economics professor Burton Malkiel suggested that while Wall Street may believe that the average manager is far more powerful and skillful than the average investor, in certain cases "a blindfolded monkey throwing darts at the Wall Street Journal can select stocks

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39. Jakab, *supra* note 9; *Passive Management, supra* note 3.

40. Jakab, *supra* note 9; *Passive Management, supra* note 3.

41. William F. Sharpe, *The Arithmetic of Active Management,* 47 FIN. ANALYST'S J. 7, 7 (1991) ("Security analysis (e.g., the graduates of prestigious business schools) must eat, and so must brokers, traders, specialists and other market-makers.").

42. *See* Robinson, *supra* note 26.

43. *See id.*

44. *See, e.g., Ultimate guide to retirement, supra* note 38.

45. *See* Alster, *supra* note 5.

46. *See, e.g.,* Sabrina Willmer, *BlackRock Cuts Dozens of Jobs and Fees in Stock-Picking Unit,* BLOOMBERG (Mar. 29, 2017, 8:58 AM), https://www.bloomberg.com/news/articles/2017-03-28/blackrock-said-to-cut-jobs-fees-in-revamp-of-active-equity-unit [https://perma.cc/YJ6Q-XYTL] (archived Aug. 22, 2018).

with as much success as professional portfolio managers."[47] This may be an extreme example, but studies support the notion that picking an index fund with low expenses may be a more efficient and equally successful approach for investors in comparison to hiring a portfolio manager.[48] Malkiel suggests that portfolio managers often fall prey to the idea that observing market returns can yield earnings forecasts, but ultimately this is a logical fallacy since calculations of past earnings are no help in predicting future growth.[49] Indeed, many studies show that picking a random group of stocks may prove to be just as effective as creating a carefully tailored portfolio.[50] This conclusion has continued to prevail decades after the publication of *A Random Walk Down Wall Street*.[51]

Beyond their lower cost and potential for better performance, index funds also provide transparency: an investor can easily find out their fund's performance simply by looking up the performance of its underlying index.[52] The idea that an investor can buy one index fund and let the market do all of the work has proven to be just as tempting as the idea of developing a secret formula of stocks and bonds to yield a high payoff. Many high-profile investors have built their wealth from passive investing: Warren Buffett is a notable example.[53] Thus, it may not be that surprising that many investors have shirked the long-standing model of active investing for the lower

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47. BURTON MALKIEL, A RANDOM WALK DOWN WALL STREET: INCLUDING A LIFE-CYCLE GUIDE TO PERSONAL INVESTING 166 (1999).

48. *Efficient Market Hypothesis*, *supra* note 7, at 60 ("Of course, the advice was not literally to throw darts, but instead to throw a towel over the stock pages—that is, to buy a broad-based index fund that bought and held all the stocks in the market and that charged very low expenses.").

49. MALKIEL, *supra* note 47, at 167; *see also* Miles Johnson, *Modern Finance Must Kick Its Addiction to Indices,* FIN. TIMES (Feb. 27, 2018), https://www.ft.com/content/b81c7540-1bd4-11e8-aaca-4574d7dabfb6 [https://perma.cc/M2ZD-FSFG] (archived Aug. 22, 2018).

50. MALKIEL, *supra* note 47, at 166, 179.

51. *See* Tom Allen and Mark Hebner, *Why Passive Investing Is Overrunning Active, in Five Charts—From the Wall Street Journal,* INDEX FUND ADVISORS (Nov. 17, 2016) https://www.ifa.com/articles/passive_investing_overrunning_active_five_charts_from_wall_street_journal/ [https://perma.cc/W7K6-VCY6] (archived Oct. 5, 2018) ("Of the 20 best-performing actively managed U.S. stock funds for 10-year returns as of the end of 2005, only seven were better than average over the next decade. Managers named by Morningstar as top performers for a given year generally didn't perform as well relative to the S&P 500 in subsequent years."); Stein, *supra* note 3; *see also* Johnson, *supra* note 49.

52. Tergesen & Zweig, *supra* note 5.

53. Jakab, *supra* note 9 ("The greatest living investor's instructions to the executors of his estate are perhaps the most convincing argument in favor of a passive approach. Mr. Buffett urged them to put 10% in short-term bonds 'and 90% in a very low-cost S&P 500 index fund. (I suggest Vanguard's.) I believe the trust's long-term results from this policy will be superior to those attained by most investors—whether pension funds, institutions or individuals—who employ high-fee managers.'").

cost and equally effective model of passive investing. However, despite the growing ubiquity of passive investing and the purported ease of investing in indices, passive investment funds are more complicated than they initially appear to be.

B. *How Is an Index Defined?*

To understand the growing role of index providers, it is crucial to first understand what it means for a passive investment fund to track an "index." As noted previously, a market index represents an aggregate value that is produced by combining several stocks or other investment vehicles together and expressing their total values against a base value from a specific date.[54] However, how "the market" is defined depends on which index the fund chooses, since index funds track individual indices that track different subsets of the market.[55] An index generally attempts to indicate the financial health of an industry in which one has invested; if an investor notices that the value of an index has dropped considerably, they may conclude that they should reevaluate their portfolio.[56]

An investor may choose an index for many reasons: for instance, perhaps they are seeking to replicate a broad swath of an economy through their investments. In the United States, the Dow Jones Industrial Average (DJIA) and the S&P 500 are good examples of indices that track the US economy. These two indices differ in how they consider market capitalization—the value of a corporation determined by multiplying the current market price of one share of the corporation by the number of total outstanding shares.[57] The S&P 500 is "capitalization-weighted," meaning that each stock's weight within the index is proportionate to its market capitalization, whereas the DJIA does not take market capitalization into account.[58] Market capitalization is significant because it allows investors to compare the size of companies.[59] Many indices focus on "small-cap,"

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54. *Market Index*, *supra* note 4.

55. Jakab, *supra* note 9. However, even when an index purports to be a "country-specific" index, it can also be difficult to draw broad conclusions, since many domestic countries conduct the majority of their business abroad. *See* Johnson, *supra* note 49.

56. *Market Index*, *supra* note 4.

57. *Market Capitalization*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/fast-answers/answersmarketcapitalizationhtm.html (last visited Sept. 3, 2018) [https://perma.cc/8B9H-96EF] (archived Aug. 22, 2018).

58. *Market Indices*, *supra* note 11.

59. The website of Fidelity Investments, a leading investment manager, notes that market capitalization, or "market cap," measures what a company is worth on the open market, as well as the market's perception of its future prospects, because it reflects what investors are willing to pay for its stock. *Understanding market capitalization*, FIDELITY INVS., https://www.fidelity.com/learning-center/trading-

"mid-cap," or "large-cap" companies, providing investors with access to a swath of companies within a certain range of market capitalization.[60]

The DJIA and S&P 500 also differ in the sectors that they represent. While the DJIA tracks thirty companies and excludes transportation and utility companies (which are included in separate indices), the S&P 500 tracks five hundred companies across a broad range of sectors.[61] These differences mean that even though both indices ostensibly seek to replicate the US economy, they do so in very different ways.[62] Consider the following explanation of price changes for each index. The DJIA's price-weighted function means that a $1 change in the price of a $120 stock in the index will have a greater effect than a $1 change in the price of a $20 stock, even though the higher-priced stock may have changed by 0.8 percent and the other by 5 percent.[63] This means that a percent change in the DJIA does not necessarily mean that the entire market has dropped by the same percent.[64] In contrast, the S&P 500 gives a good indication of movement in the US marketplace as a whole because the S&P 500 is capitalization-weighted (also known as market weighted). Therefore, if the total market value of all five hundred companies drops by 10 percent, the value of the index also drops by 10 percent.[65]

investing/fundamental-analysis/understanding-market-capitalization (last visited Sept. 3, 2018) [https://perma.cc/J3VC-9LUP] (archived Aug. 22, 2018).

60. Large-cap companies (typically with a market capitalization of greater than USD $10 billion) are often established market players, and as such, an investment in large-cap stocks is often considered a more conservative investment. On the flip side, small-cap companies are usually young companies that may serve niche or emerging industries, often have a market capitalization of USD $300 million to USD $2 billion, and are considered a riskier investment. Mid-cap companies are typically established companies experiencing rapid growth, and fall somewhere in between large- and small-cap companies on the risk/return spectrum. *See id.*

61. *See Dow Jones Industrial Average Index*, CNN MONEY, http://money.cnn.com/data/dow30/ (last visited Aug. 22, 2018); *S&P 500 Stocks*, MARKETS INSIDER, http://markets.businessinsider.com/index/components/s&p_500/ (last visited Aug. 22, 2018).

62. Katie Schick, *An Introduction to Stock Market Indexes*, INVESTOPEDIA (Apr. 27, 2017, 1:50 PM), https://www.investopedia.com/insights/introduction-to-stock-market-indices/ [https://perma.cc/ZRK2-GQY7] (archived Aug. 22, 2018).

63. *Id.*

64. *Id.* ("A change in the Dow represents changes in investors' expectations of the earnings and risks of the large companies included in the average . . . . On the other hand, because the Dow is made up of some of the most well-known companies in the U.S., large swings in this index generally correspond to the movement of the entire market, although not necessarily on the same scale.").

65. *Id.* ("A 10% movement in all stocks in the DJIA, by contrast, would not necessarily cause a 10% change in the index. Many people consider the market weighting used in the S&P 500 to be a better measure of the market's movement because two portfolios can be more easily compared when changes are measured in percentages rather than dollar amounts.").

The use of price weighting versus market weighting leads to very different results for these two indices, each of which are widely used by investors in passive investment funds.[66] However, passive investment funds are not limited to tracking large indices like the S&P 500 and the DJIA, or even to indices that track an entire economy from another country (such as the Hang Seng Index or the FTSE 100 Index).[67] Many investors may want a slightly narrower set of investments, such as investments in emerging markets, developing markets, "frontier" countries, or in technology, healthcare, or infrastructure. Each of these narrower indices also represents "the market," albeit a different swath of it.

This Note focuses primarily on the effects of index providers' decisions on individual countries' economies. Generally, the countries that are more likely to be affected by these decisions are those with smaller economies or that are considered "frontier" or "emerging" markets, rather than those with more robust economies, typically referred to as "developed" markets.

Frontier markets typically refer to poorer countries that are in the process of developing and therefore have the possibility of rapid growth.[68] This rapid growth is often attractive to investors who may have lost out on investment opportunities in other, more developed countries while they were in a period of growth.[69] The downside of this potential for rapid growth is that frontier countries have much lower levels of liquidity.[70] MSCI's Frontier Markets Index captures large- and mid-capitalization across twenty-nine frontier markets

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66. *See, e.g.*, Ray Martin, *Why the S&P 500 is a better gauge than the Dow,* CBS MONEYWATCH (Aug. 28, 2014, 2:38 PM), https://www.cbsnews.com/news/dow-jones-industrial-average-sp-500-which-is-better/ [https://perma.cc/FUQ7-QUQD] (archived Aug. 22, 2018).

67. Some of the major Asian indices include the Hang Seng Index, which tracks the Hong Kong Stock Exchange, the Shanghai SE Composite Index, which tracks the Shanghai Stock Exchange, and the Nikkei 225 Index, which tracks the top 225 companies listed on the Tokyo Stock Exchange. *See Hang Seng Composite Index,* BLOOMBERG MARKETS, https://www.bloomberg.com/quote/HSCI:IND (last visited Aug. 22, 2018); *Nikkei 225 Index,* BLOOMBERG MARKETS, https://www.bloomberg.com/quote/NKY:IND (last visited Aug. 22, 2018); *Shanghai Stock Exchange Index,* BLOOMBERG MARKETS, https://www.bloomberg.com/quote/SHCOMP:IND (last visited Aug. 22, 2018); *World Markets,* CNN MONEY, http://money.cnn.com/data/world_markets/asia/ (last visited Aug. 22, 2018). The FTSE 100 Index is not part of a stock exchange but contains 80 percent of the market capitalization of the London Stock Exchange and is one of the most popular indices around the world. *See FTSE,* INVESTOPEDIA, https://www.investopedia.com/terms/f/ftse.asp (last visited Sept. 3, 2018) [https://perma.cc/5QHS-4M7Z] (archived Aug. 22, 2018); *FTSE 100 Index,* BLOOMBERG MARKETS, https://www.bloomberg.com/quote/HSCI:IND (last visited Aug. 22, 2018).

68. Simon Constable, *What are Frontier Markets?*, WALL ST. J. (June 7, 2015, 11:03 PM), https://www.wsj.com/articles/what-are-frontier-markets-1433527631 [https://perma.cc/9N8G-5ZFT] (archived Aug. 22, 2018).

69. *Id.*

70. *Id.*

countries.[71] Dow Jones' S&P Frontier BMI draws stocks from thirty-four "small and illiquid markets that have not yet reached emerging market status."[72] FTSE's Frontier Index Series draws from twenty-nine different countries' large-, mid-, and small-capitalization equity securities.[73] There is a lot of overlap among the countries included in these indices, but they are not identical, perhaps reflecting the constantly changing nature of frontier economies.[74]

Emerging markets are typically described as markets in developing countries that have the potential for rapid growth, but that may also be volatile.[75] However, the term "emerging markets" may be slightly confusing, because while many volatile developing countries are considered emerging, so too are some of the world's largest economies.[76] As *The Economist* succinctly puts it, an emerging market is "broadly speaking, an economy that is not too rich, not too poor and not too closed to foreign capital."[77] Dow Jones' S&P Emerging BMI Index captures all "companies domiciled in the

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71. These countries include Argentina, Bahrain, Bangladesh, Burkina Faso, Benin, Croatia, Estonia, Guinea-Bissau, Ivory Coast, Jordan, Kenya, Kuwait, Lebanon, Lithuania, Kazakhstan, Mauritius, Mali, Morocco, Niger, Nigeria, Oman, Romania, Serbia, Senegal, Slovenia, Sri Lanka, Togo, Tunisia, and Vietnam. *MSCI Frontier Markets Index,* MSCI (July 31, 2018), https://www.msci.com/documents/10199/f9354b32-04ac-4c7e-b76e-460848afe026 [https://perma.cc/GN8U-LVTF] (archived Aug. 22, 2018).

72. These countries include Argentina, Bahrain, Bangladesh, Botswana, Bulgaria, Cote D'Ivoire, Croatia, Cyprus, Ecuador, Estonia, Ghana, Jamaica, Jordan, Kazakhstan, Kenya, Kuwait, Latvia, Lebanon, Lithuania, Mauritius, Morocco, Namibia, Nigeria, Oman, Panama, Romania, Slovakia, Slovenia, Sri Lanka, Trinidad and Tobago, Tunisia, Vietnam, and Zambia. *See S&P Frontier BMI,* S&P DOW JONES INDICES, http://us.spindices.com/indices/equity/sp-frontier-bmi-us-dollar (last visited Sept. 3, 2018) [https://perma.cc/4JV7-B67D] (archived Aug. 22, 2018).

73. These countries include Argentina, Bahrain, Bangladesh, Botswana, Bulgaria, Croatia, Cyprus, Estonia, Cote D'Ivoire, Ghana, Jordan, Kazakhstan, Kenya, Latvia, Lithuania, Macedonia, Malta, Mauritius, Morocco, Nigeria, Occupied Palestinian Territory, Oman, Romania, Serbia, Slovakia, Slovenia, Sri Lanka, Tunisia, and Vietnam. FTSE RUSSELL FACTSHEET, FTSE FRONTIER INDEX SERIES, FTSE RUSSELL (June 2018); FTSE RUSSELL, FTSE COUNTRY CLASSIFICATION PROCESS 9 (Mar. 2018), http://www.ftse.com/products/downloads/FTSE_Country_Classification_Paper.pdf [https://perma.cc/VE2F-EPU4] (archived Aug. 22, 2018) [hereinafter FTSE COUNTRY CLASSIFICATION].

74. For instance, MSCI includes a greater number of African countries in its index, including Burkina Faso, Benin, Guinea-Bissau, Mali, Namibia, Niger, Senegal, and Togo. *MSCI Frontier Markets Index, supra* note 71.

75. *See* Ashoka Mody, *What Is an Emerging Market?* 3 (Int'l. Monetary Fund, Working Paper No. 04/177).

76. For instance, *The Economist* notes that the emerging-markets group "has also become more prosperous and more Asian. The World Bank now classifies nine of MSCI's 24 benchmark economies as high-income." *What's in a name? Defining emerging markets,* THE ECONOMIST (Oct. 7, 2017), https://www.economist.com/news/special-report/21729866-self-fulfilling-prophecy-defining-emerging-markets [https://perma.cc/CG3Q-JDJY] (archived Aug. 22, 2018).

77. *Id.*

emerging markets within the S&P Global BMI with a float-adjusted market capitalization of at least USD $100 million and a minimum annual trading liquidity of USD $50 million," and is segmented by country/region, size (large, mid, and small), style (value and growth), and "global industry classification standard" (sectors/industry groups).[78] The MSCI Emerging Markets Index captures large- and mid-cap representation across twenty-four countries, covering around 85 percent of the "free float-adjusted market capitalization" in each country.[79] The FTSE Emerging Market Index includes large- and mid-cap securities from advanced and secondary emerging markets, classified in accordance with FTSE's transparent Country Classification Review Process, and seeks to provide investors with a "comprehensive means of measuring the performance of the most liquid companies in the emerging markets."[80] FTSE also categorizes "emerging markets" further into "advanced" or "secondary," reflecting that some of the countries typically considered "emerging" have economies that are much larger and more developed relative to their peers.[81] Overall, there is very little difference in the countries considered to be emerging for each of these index providers, which may reflect that "emerging market" countries are more entrenched in the global economy than their more volatile frontier market peers, which may be subject to rapid growth and rapid loss at any given moment.

The terms "emerging" and "frontier" may not seem like they have much weight, given that different index providers assign different countries to their rankings. Further complicating matters, MSCI assigns some countries to "standalone" market indices, meaning that

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78. These countries include Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey, and the United Arab Emirates. *S&P Emerging BMI,* S&P DOW JONES INDICES, https://us.spindices.com/indices/equity/sp-emerging-bmi-us-dollar (select "Factsheet;" then select "Month-End") (last visited Sept. 3, 2018).

79. These countries include Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Russia, Qatar, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates. *MSCI Emerging Markets Index,* MSCI (2018), https://www.msci.com/documents/10199/c0db0a48-01f2-4ba9-ad01-226fd5678111 [https://perma.cc/3AB7-LTGR] (archived Aug. 22, 2018).

80. These countries include Brazil, Chile, China, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey, and the United Arab Emirates. FTSE EMERGING INDEX, FTSE RUSSELL (July 2018).

81. The countries considered "Advanced Emerging" as of September 2017 are Brazil, Czech Republic, Greece, Hungary, Malaysia, Mexico, Poland, South Africa, Taiwan, Thailand, and Turkey. Poland will be promoted to Developed status in September 2018. FTSE ANNUAL COUNTRY CLASSIFICATION REVIEW, FTSE RUSSELL (2017), https://www.ftse.com/products/downloads/FTSE-Country-Classification-Update-2017.pdf [https://perma.cc/DWR6-6ENT] (archived Aug. 22, 2018).

they are not included in the emerging or frontier indices, but the countries are assigned to either group depending on size and liquidity.[82] For instance, prior to its inclusion in MSCI's Emerging Markets Index, Saudi Arabia had its own index within the "emerging" category, while various other countries have standalone indices and are considered frontier markets.[83] MSCI also lists the West African Economic and Monetary Union (WAEMU), comprised of Benin, Burkina Faso, Ivory Coast, Guinea-Bissau, Mali, Niger, Senegal, and Togo, as a frontier market.[84] Although each of these countries is included in the broader MSCI Frontier Index, MSCI also has a separate WAEMU Index.[85]

The final category used for classifying countries is "developed" markets. This phrase typically refers to countries that are economically advanced and that have highly developed capital markets with high levels of liquidity, developed regulatory bodies, large market capitalization, and high levels of per capita income.[86] Interestingly, Dow Jones, MSCI, and FTSE include nearly identical lists of countries in their developed markets indices.[87] However, both FTSE and Dow Jones list South Korea as a developed market, while MSCI includes South Korea in its emerging markets index; the only other difference between the three indices is that Dow Jones also includes Luxembourg in its developed markets.[88]

It's understandably confusing to see that certain high profile index providers list one country's economy as developed while others suggest it is emerging. Investors rely on these definitions to make investment decisions, and the vocabulary used by index providers can have certain connotations.[89] Although all three of the index providers

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82. *Market Classification*, MSCI, https://www.msci.com/market-classification (last visited Sept. 3, 2018) [https://perma.cc/8PFS-FEC9] (archived Aug. 22, 2018).

83. These countries are Jamaica, Panama, Trinidad & Tobago, Bosnia and Herzegovina, Bulgaria, Ukraine, Botswana, Ghana, Zimbabwe, and Palestine. *Id.*

84. *Id.*

85. *Id.*

86. *What is the difference between a developed, emerging, and frontier market?* , NASDAQ (May 11, 2012, 10:00 AM), https://www.nasdaq.com/article/what-is-the-difference-between-a-developed-emerging-and-frontier-market-cm140649 (last visited Aug. 22, 2018).

87. These countries are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States. *See* FTSE DEVELOPED INDEX, FTSE RUSSELL (Jul. 2018); *Market Classification*, *supra* note 82; *S&P Developed BMI*, S&P DOW JONES INDICES, https://us.spindices.com/indices/equity/sp-developed-bmi-us-dollar (last visited Sept. 3, 2018) [https://perma.cc/6XFM-D3RQ] (archived Aug. 22, 2018).

88. *See* FTSE DEVELOPED INDEX, *supra* note 87; *Market Classification*, *supra* note 82; *S&P Developed BMI*, *supra* note 87.

89. Nasdaq suggests that these terms have commonly understood meanings that may not correspond to the countries considered to be within these categories. *See*

discussed in this Note use different methodologies, their classification systems result in almost identical lists of countries in each category, especially with regards to emerging and developed markets. The effect of the slight differences in index providers' classifications of countries can lead to different results for investors. In Part III, this Note digs deeper into the research and methodology used by these three index providers to determine why countries are sorted into different categories.

III. LEADING INDEX PROVIDERS AND THEIR PROPRIETARY RESEARCH MODELS

A. *Dow Jones*

The Dow Jones website contains various documents that describe the methodology behind its indices, which are broken down either by asset class or by region.[90] This Note focuses on the breakdown by region. Dow Jones breaks down its regional indices into five subcategories, which are further broken down into more specific categories.[91] For ease of reference this list is reproduced below in chart form:[92]

What is the difference between a developed, emerging, and frontier market?, *supra* note 86 ("While, in general, developed markets are considered safer than emerging markets, and the more developed emerging markets safer than frontier markets, this is not a rule that can be applied unequivocally. When Singapore, Taiwan, and South Korea are called emerging markets by some entities, and Greece and Portugal are categorized as developed markets, it's apparent that developed markets are not always safer than emerging ones.").

90. *Global: All*, S&P DOW JONES INDICES, https://us.spindices.com/regional-exposure/global/all (last visited Sept. 4, 2018) [https://perma.cc/BGS3-5Y5J] (archived Aug. 22, 2018).

91. *Id.*

92. *Id.*

Global	**Americas**	**Europe**	**Middle East & Africa**	**Asia Pacific**
Developed	Pan Regional	Pan Regional	Pan Regional	Pan Regional
Emerging	United States		Pan Arab & Gulf Cooperation Council (GCC)	Australia & New Zealand
Frontier	Canada		Israel	China
	Pacific Alliance (Chile, Colombia, Mexico, Peru)		Africa	India
	Brazil		South Africa	Japan
	Chile			South Korea
	Mexico			
	Peru			

Each of the index providers discussed in this Note has its own specific methodology for determining how to classify countries. To determine which countries are included in the Dow Jones indices, Dow Jones first uses quantitative criteria that are described in this Part to determine an initial classification.[93] Following this quantitative criteria process, Dow Jones creates a list of countries that are included on the annual Country Classification Consultation.[94] The final classifications are made by the S&P Dow Jones Indices Global Equity Index Committee and are based on both the Country Classification Consultation and the quantitative criteria.[95]

93. S&P DOW JONES INDICES, COUNTRY CLASSIFICATION METHODOLOGY 2 (2018), http://us.spindices.com/documents/index-policies/methodology-country-classification.pdf [https://perma.cc/MKT4-VFWY] (archived Aug. 22, 2018) [hereinafter S&P COUNTRY CLASSIFICATION].

94. *Id.*

95. *Id.*

A country must meet threshold criteria to be considered for the Country Index Series.[96] Those countries that meet "the most minimum of requirements" will be eligible for inclusion in the Frontier region; countries seeking to be included in Developed or Emerging classifications must meet an additional measure of country economic status and other criteria. Countries must then engage in an "in-depth client consultation assessing operational standards in those countries" before they may be reassigned from their current status.[97] Countries must meet a minimum of two of the three following baseline criteria to be eligible for the country indices: full domestic market capitalization, annual turnover value of over USD $1 billion, and a market development ratio of over 5 percent.[98] If a country meets two of these three requirements, it can be considered for Frontier status.[99]

Once a country meets the baseline criteria for inclusion in Frontier markets, it must then meet additional criteria to be considered Emerging.[100] Emerging countries must meet all three of the baseline criteria and must meet a minimum of three of the following five criteria to be considered Emerging.[101] These criteria include: a settlement period of three business days,[102] sovereign debt

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96. *Id.*

97. *Id.*

98. With regards to the first requirement of market capitalization, Dow Jones "uses the full market capitalization of an exchange's primary market as its measure, sourced from independent data vendors." *Id.* Float-adjusted market capitalization is not used, as the availability of float information for smaller markets is not of the required standard for consistency across all markets." *Id.* Dow Jones also requires an annual turnover value over USD $1 billion, meaning "[t]he total value traded of all equity securities listed on a country's domestic exchange must meet this threshold over the previous calendar year." *Id.* Finally, Dow Jones' website notes that "many countries have very small equity markets that do not provide a sufficiently robust representation of the domestic market economy. To ensure that only markets that have developed sufficiently are used, S&P Dow Jones Indices calculates a 'market development ratio' by dividing the full domestic market capitalization of the exchange by the country's nominal GDP. To be considered for the S&P Dow Jones Indices Country Indices this figure must be over 5%." *Id.*

99. *Id.*

100. *Id.*

101. *Id.*

102. The settlement period refers to the cycle for most broker-dealer securities transactions, and S&P requires the period to be "T+3 or better." *Id.* at 3. According to the SEC, "T+3" is shorthand that means the "trade date plus three days." *About Settling Trades In Three Days: Introducing T+3*, U.S. SEC. & EXCH. COMM'N (May 21, 2004), https://www.sec.gov/reportspubs/investor-publications/investorpubstplus3htm.html [https://perma.cc/4EL8-4WNJ] (archived Aug. 22, 2018). This rule means that when you buy securities, the brokerage firm must receive your payment no later than three business days after the trade is executed. *Id.* When you sell a security, you must deliver to your brokerage firm your securities certificate no later than three business days after the sale. *Id.* The SEC's justification for this rule is that "the longer the period from trade execution to settlement, the greater the risk that securities firms and investors hit by sizable losses would be unable to pay for their transactions." *Id.* The

rated investment grade by major ratings agencies,[103] non-occurrence of hyperinflation,[104] no significant foreign-ownership restrictions,[105] and free trade of the country's currency.[106] The country must also have a total market capitalization of over USD $15 billion.[107]

To be considered for Developed status, countries must meet all eight of the previously listed criteria and have a nominal gross domestic product (GDP) per capita, at Purchasing Power Parity (PPP), of greater than USD $15,000.[108]

Once a change in classification is being considered, Dow Jones will engage in the Client Consultation on Operational Standards, which assesses "primarily operational matters."[109] These matters include the country's regulatory environment, market structure, trading environment, and market consensus.[110] Dow Jones' website notes that "country classification is both an art and a science" and emphasizes the importance of both the quantitative and qualitative criteria.[111]

SEC recently shortened the settlement period to "T+2" effective September 5, 2017. Press Release, U.S. Sec. & Exch. Comm'n, SEC Adopts T+2 Settlement Cycle for Securities Transactions (Mar. 22, 2017), https://www.sec.gov/news/press-release/2017-68-0 [https://perma.cc/6DRF-QJ2B] (archived Aug. 22, 2018).

103. This is due to concerns that a company's ability to operate is directly affected by its home country's financial situation. Dow Jones stipulates that ratings should be BB+ or higher by S&P and Fitch, and Baa or higher by Moody's. S&P COUNTRY CLASSIFICATION, *supra* note 93. For a more in-depth explanation of credit ratings definitions, see MOODY'S INVESTORS SERVICE, RATING SYMBOLS AND DEFINITIONS (June 2018), https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004 (last visited Sept. 4, 2018) [https://perma.cc/ZXY6-BM3F] (archived Sept. 4, 2018); *Rating Definitions,* FITCH RATINGS, https://www.fitchratings.com/site/definitions (last visited Sept. 4, 2018) [https://perma.cc/9WZ3-QMUM] (archived Aug. 22, 2018); *S&P Global Ratings Definitions,* S&P DOW JONES (Apr. 19, 2018, 8:02 AM), https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 [https://perma.cc/7SFY-TSFQ] (archived Aug. 22, 2018).

104. Dow Jones' country classification methodology defines hyperinflation as an annual rate of change in the market's consumer price index of over 25 percent at the time of the review. S&P COUNTRY CLASSIFICATION, *supra* note 93.

105. Foreign ownership restrictions cause issues in achieving the required exposure to stocks in a given market. While Dow Jones recognizes that stocks in certain industries are commonly restricted, markets should be broadly open. *Id.*

106. Difficulties buying or selling a domestic currency or repatriating capital from a market hugely complicate the process of investing in a given market. *Id.*

107. *Id.*

108. *Id.*

109. *Id.*

110. Within these sub-categories, the Client Consultation on Operational Standards takes into account factors such as the existence of regulatory infrastructure; equitable treatment of minority shareholders; ease of repatriation of capital/income; ease of entry for foreign investors; existence of foreign exchange, futures and options, and custodial markets; and different facets of the trading environment, including brokerage services, broad market liquidity, and "appropriate, but not punitive" capital gains taxes. *Id.* Dow Jones also looks for a "desire for change" in the country's market status by contacting the investor community and canvassing for opinions. *Id.*

111. *Id.*

Up until the Client Consultation on Operational Standards, it appears that the standards used by Dow Jones are fairly objective. However, the consideration of "primarily operational matters" introduces a more subjective viewpoint into the process.[112] Additionally, Dow Jones states that "there must be market consensus desiring the change to a country's market status . . . S&P Dow Jones Indices' staff is in constant contact with the investor community, and regularly canvas opinion concerning new countries of interest and issues of concern with existing S&P Dow Jones Indices Global Equity Index countries."[113] It is unclear which types of constituents make up the "investment community." However, Dow Jones also solicits feedback through a survey to the investment community, and that survey specifically notes the value of institutional investors' opinions and experience.[114] Dow Jones also notes that they are under no obligation to consider the feedback within the survey.[115] This introduces an element of subjectivity to the classification process: if a country that wants to be reclassified from Frontier to Emerging makes it past the objective criteria, but various institutional investors push back against its reclassification in survey responses, Dow Jones may take their opinions into consideration and decide against reclassification. This could prove to be problematic for countries working to establish their presence in the international markets. The next two subparts within this Part will discuss the country classification methodologies used by MSCI and FTSE.

B. *MSCI Inc.*

MSCI's website breaks down its indices into a number of categories: market cap, factor, strategy, thematic, environmental, social, and governance (ESG), custom, and real estate.[116] This Note focuses on the indices included under "Market Cap." The breakdown of indices in this category is partially reproduced here in chart form:[117]

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112. *Id.*

113. *Id.*

114. Press Release, S&P Dow Jones Indices, S&P Dow Jones Indices' Annual Country Classification Consultation (June 15, 2017), https://us.spindices.com/documents/index-news-and-announcements/20170615-spdji-annual-country-classification-consultation.pdf [https://perma.cc/HEG4-9NYE] (archived Aug. 22, 2018) [hereinafter S&P Annual Country Classification].

115. *Id.*

116. *Market Cap Indexes,* MSCI, https://www.msci.com/market-cap-weighted-indexes (last visited Sept. 4, 2018) [https://perma.cc/73JY-7H7K] (archived Aug. 22, 2018).

117. See *supra* Part II.B for a complete list of MSCI's classifications of developed, emerging, and frontier markets and its standalone market indices.

<table>
<tr><th colspan="4">MSCI ALL COUNTRY WORLD INDEX (ACWI)
& FRONTIER MARKETS INDEX</th></tr>
<tr><th colspan="2">MSCI ACWI Index</th><th colspan="2">MSCI Emerging &
Frontier Markets Index</th></tr>
<tr><td>MSCI World Index</td><td colspan="2">MSCI Emerging Markets Index</td><td>MSCI Frontier Markets Index</td></tr>
<tr><td><u>Developed Markets</u>:
Americas, Europe, Middle East, Pacific</td><td colspan="2"><u>Emerging Markets</u>:
Americas, Europe, Middle East, Africa, Asia</td><td><u>Frontier Markets</u>:
Americas, Europe, Commonwealth of Independent States (CIS), Africa, Middle East, Asia</td></tr>
</table>

Similar to Dow Jones, each MSCI index has its own methodology, and each country must meet certain thresholds in order to be included in a given investment universe. MSCI notes that its approach "aims to reflect the views and practices of the international investment community by striking a balance between a country's economic development and the accessibility of its market while preserving index stability."[118] The criteria considered are economic development, size, liquidity, and market accessibility.[119]

Frontier countries must have at least two companies that meet specified thresholds for company size, security size, and security liquidity.[120] They must also have "at least some" openness to foreign ownership,[121] "at least partial" ease of capital inflows/outflows,[122]

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118. MSCI, MSCI GLOBAL INVESTABLE MARKET INDEXES METHODOLOGY 98 (Nov. 2017), https://www.msci.com/eqb/methodology/meth_docs/MSCI_November2017_GIMI Methodology.pdf [https://perma.cc/4NAW-CCTZ] (archived Aug. 22, 2018) [hereinafter MSCI GLOBAL INDEXES].

119. The size and liquidity requirements are based on minimum investability requirements for MSCI Global Standard Indexes. *See id.*

120. The minimum standards for company size and security size are based on the minimum in use for the November 2017 Semi-Annual Index Review, updated on a semi-annual basis. *See id.*

121. MSCI, MSCI GLOBAL MARKET ACCESSIBILITY REVIEW 54 (June 2017), https://www.msci.com/documents/1296102/1330218/MSCI_Global_Market_Accessibility_Review_June+2017+%28FINAL%29/edcbfb6b-fa40-4810-9f1e-8131fae428f7 [https://perma.cc/L8PV-L92G] (archived Aug. 22, 2018). Within this category, MSCI considers investor qualification requirements, foreign ownership limit levels (or percentage of the market available to non-domestic investors), foreign room levels (or proportion of shares available to non-domestic investors), and equal rights to foreign investors. *Id.* at 60. For a more in-depth discussion of the subfactors, see *id.* at 4–8, 63.

122. *Id.* at 54. Within this category, MSCI considers capital flow restriction levels and foreign exchange market liberalization levels. *Id.* at 60.

modest efficiency of operational framework,[123] high competitive landscape,[124] and modest stability of institutional framework.[125] Frontier countries do not have a requirement for economic development, due to their wide variety of development levels.[126]

Emerging market countries must have at least three companies that meet higher levels of size and liquidity.[127] They must have "significant" openness to foreign ownership and ease of capital inflows/outflows, "good and tested" efficiency of operational framework, a highly competitive landscape, and modest stability of institutional framework.[128] As with frontier markets, emerging markets do not have a requirement for economic development.[129]

Developed markets must have a gross national income (GNI) per capita of 25 percent above the World Bank high-income threshold for three consecutive years.[130] They must have at least five companies meeting specified size and liquidity requirements.[131] They must also have very high openness to foreign ownership, ease of capital inflows/outflows, efficiency of operational framework, and stability of institutional framework, as well as an unrestricted competitive landscape.[132]

MSCI's requirements for inclusion in certain indices differ slightly from those used by Dow Jones, most notably in that they focus on characteristics of companies within a country, rather than just focusing on more general measures for a country's economy, such as market capitalization. The economic-development levels and size and liquidity requirements are quantitative measures; however, market accessibility is assessed through a more qualitative framework that aims to reflect international investors' experiences investing in a given market.[133] This is conducted through MSCI's annual Global Market Accessibility Review, where MSCI seeks out

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123. *Id.* at 54. Within this category, MSCI assesses market entry, organization, and infrastructure. *Id.* at 60.

124. *Id.* at 54. "Competitive landscape" is defined as the existence of anti-competitive clauses restricting investors' access to derived stock exchange information, data and investment products. *Id.* at 63. MSCI notes that anti-competitive clauses should not result in global or regional financial products breaching local market rules, regulations or other restrictions. *Id.*

125. *Id.* at 54. This category encompasses the rule of law and its enforcement, as well as the stability of the "free-market" economic system and a country's track record of government intervention with regards to foreign investors. *Id.* at 63.

126. *Id.* at 54.

127. *See id.*

128. *See id.*

129. *See id.*

130. *Id.* In 2016, the high-income threshold was a GNI per capita of USD $12,476. *Id.*

131. *Id.*

132. *Id.*

133. *See id.* at 55

feedback from active and passive asset managers, asset owners, brokers, custodians, stock exchanges, and regulators.[134] Although MSCI's website notes that the criteria are qualitative, it also states that the individual measures are "absolute in the sense that the analysis and the assessment were performed in the same way across all countries regardless of their current market classification."[135] MSCI also emphasizes the usefulness of feedback from the "investment community" to ensure that its assessment accurately reflects the experiences of international institutional investors.[136]

MSCI's system is similar to Dow Jones' system, but its Global Market Accessibility Review contains very detailed descriptions of each factor and subfactor, with clear statements that the absence or presence of certain factors will lead to a low assessment.[137] This may lead to more clarity in the process, but the emphasis on investment-community feedback may also lead to similar issues as described in Part III.A above.

C. *FTSE Group*

Like MSCI, FTSE also breaks down its indices by type; this Note focuses on the market capitalization weighted indices, which are further broken down into Global, Europe/Middle East/Africa (EMEA), Americas, and Asia Pacific.[138] When reclassifying countries, FTSE uses its own Country Classification Process, described as a formal process for assessing markets.[139] The Country Classification Process is comprised of the following elements: a Quality of Markets matrix, a questionnaire for stock exchanges and regulatory authorities, an FTSE Russell Country Classification Advisory Committee that reports to the FTSE Russell Policy Advisory Board, a Watch List for countries meeting or close to meeting the Quality of Markets criteria, a policy of engagement with markets placed on the Watch List, an annual schedule for determining country classification and Watch List changes, and a defined communication and implementation table.[140]

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134. *See id.*

135. *Id.* at 3.

136. *Id.*

137. *See id.* at 4–5.

138. *All Index Families*, FTSE RUSSELL, http://www.ftse.com/products/indexmenu (last visited Sept. 4, 2018) [https://perma.cc/M5CF-3P76?type=image] (archived Aug. 22, 2018).

139. *See* FTSE COUNTRY CLASSIFICATION, *supra* note 73, at 3.

140. *See id.*

The Quality of Markets matrix is divided into four sections: dealing landscape and brokers,[141] custody and settlement,[142] regulation,[143] and derivatives.[144] Each section is broken down further into subcategories, and each market is scored as "pass," "restricted," or "not met."[145] Developed markets should pass every category (although a few restricted scores may be allowed); advanced emerging markets must pass fewer, while secondary emerging and frontier markets must pass even fewer categories.[146] FTSE also tracks the creditworthiness and the World Bank GNI per capita rating for countries seeking reclassification.[147]

FTSE also utilizes a questionnaire for countries that have not been evaluated or where reassessment is considered timely.[148] This questionnaire is typically sent to contacts at a stock exchange and invites responses to criteria covered by the Quality of Markets Matrix and breaks the criteria down further into essential details.[149] A country's answers to the questionnaire help FTSE form a determination of that country's score.[150]

The Advisory Committee, which is comprised of market practitioners with technical expertise in trading, portfolio management, and custody, reviews Quality of Markets matrices and engagement questionnaires, and ultimately decides on changes to scores.[151] The Advisory Committee may also undertake its own

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141. *Id.* at 4. Within this category, FTSE considers the following sub-factors: existence of sufficient competition to ensure high quality broker services; sufficient broad market liquidity; reasonable and competitive transaction costs; stock lending; short sales; off-exchange transactions; efficient trading mechanisms; transparency. *See id.* at 8. For a more detailed breakdown of all factors, see *id.*

142. *Id.* at 4. FTSE considers the following sub-factors: rare incidence of failed trades; sufficient competition to ensure high quality custodian services; T+2/T+3 clearing and settlement periods; free settlement delivery; and omnibus and segregated account facilities. *See id.* at 8.

143. *Id.* at 4. FTSE considers the following sub-factors: formal stock market regulatory authorities actively monitoring the market; fair/non-prejudicial treatment of minority shareholders; no/selective incidence of foreign ownership restrictions; little or no restrictions or penalties on investment of capital or repatriation of capital or income; free and well-developed equity and foreign exchange markets; and a simple registration process for foreign investors (or no registration at all). *See id.* at 8.

144. *Id.* at 4. This category considers whether there is a developed derivatives market. *See id.* at 8.

145. *Id.* at 4.

146. *Id.*

147. *See id.* at 8.

148. *Id.* at 4.

149. *Id.*

150. *Id.*

151. *Id.* ("Each country's scores on the Quality of Markets matrix are kept under review and proposals for changes to scores are debated at the meetings of the FTSE Russell Country Classification Advisory Committee. Any changes to the scores recommended by the Committee are duly minuted and changes to country scores are

research or check with colleagues to determine whether a response is correct.[152]

The Policy Advisory Board, which is the most senior of FTSE Russell's external advisory committees and draws its membership from senior personnel at investment management companies, investment consultants, and asset owners, ensures that the final analysis for country classification is consistent with "perceptions of seasoned investors at that time."[153]

The Watch List is comprised of countries whose scores on the Quality of Markets matrix are either close to meeting or have met the criteria for reclassification, or countries whose scores have fallen and are being considered for demotion.[154] A country must stay on the Watch List for at least one year, and potentially several years, before it is considered ready for reclassification.[155]

FTSE's system is relatively similar to the systems used by Dow Jones and MSCI—all three providers use a blend of defined quantitative factors and more subjective qualitative assessments. However, FTSE seems to have less clearly defined requirements for a country's classification as frontier, emerging, or developed.[156] All three index providers also solicit feedback from the greater investment community, though none of the providers describe this process in great detail, nor do they specify which types of community members are surveyed, other than institutional investors. However, FTSE does note that its committees are made up of market practitioners or people working in the investment management industry, again suggesting that the focus of the more qualitative measures are to glean responses from institutional investors or other key market players rather than retail investors. The next Part will build on the discussion of each provider's methodology to analyze various risks and outcomes leading from index providers' decisions.

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formally communicated by FTSE Russell to the relevant authorities each year in March and September.").

152. *Id.*

153. *Id.*

154. *Id.* at 5.

155. *Id.* ("This is consistent with the principles set out earlier that countries should only change classification infrequently, when the appropriate standards have been confirmed for a period of time, and that investors should be forewarned of the prospect. A seasoning period on the Watch List thus allows investors to become comfortable that the technical criteria assessed through the Quality of Markets framework are indeed being met in practice.").

156. *See, e.g.*, *id.* at 8.

IV. THE RISKS AND OUTCOMES OF INDEX PROVIDERS' CAPITAL ALLOCATION DECISIONS

Dow Jones, MSCI, and FTSE each use their own blend of proprietary strategies to determine whether countries should be classified as developed, emerging, or frontier. As discussed in Part III, these different strategies often result in almost identical lists of countries, at least with respect to classifications within developed and emerging markets.[157] However, even if the index providers' different classification systems lead to similar results, decisions regarding the classification of each country often have risks and consequences for international investors, the markets of the countries being reclassified, and the market as a whole. Part IV of this Note discusses these risks and outcomes in depth.

A. *Lack of Transparency for Investors*

Dow Jones, MSCI, and FTSE each describe their proprietary country classification systems as transparent for investors.[158] However, in comparison to mandatory financial disclosures, such as those required by the SEC, these classifications are much less in-depth and may be difficult to find.[159] Index providers' disclosures are provided as a courtesy, rather than in response to statutory

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157. *See supra* Part III; *see also* NASDAQ, A CLOSER LOOK: COUNTRY CLASSIFICATIONS AMONG INDEX PROVIDERS, (Oct. 2013), https://indexes.nasdaqomx.com/docs/Closer_Look_Country_Classification_NQGI.pdf [https://perma.cc/QDM6-ZAVK] (archived Aug. 22, 2018).

158. *See Country Classification Conundrums*, ETF (Feb. 22, 2011), http://www.etf.com/publications/journalofindexes/joi-articles/8835-country-classification-conundrums.html?nopaging=1 [https://perma.cc/TH7U-PX7C] (archived Aug. 22, 2018) ("At MSCI, we have a transparent methodology to classify markets in frontier, emerging and developed markets."); *see also* FTSE COUNTRY CLASSIFICATION, *supra* note 73 ("Since its inception in 2003, the FTSE country classification process has matured into a transparent and objective mechanism of classifying markets in a way that is designed to meet the ongoing needs of institutional investors."); S&P Annual Country Classification, *supra* note 114 ("With over 1,000,000 indices and more than 120 years of experience constructing innovative and transparent solutions, S&P Dow Jones Indices defines the way investors measure and trade the markets.").

159. For example, mutual funds are considered "investment companies" regulated under the Investment Company Act of 1940, so they must file a prospectus and shareholder report with the SEC, as well as comply with various other periodic reporting requirements. For a brief explanation of certain registration and regulation requirements for investment companies, see *Investment Company Registration and Regulation Package*, U.S. SEC. & EXCH. COMM'N (Feb. 19, 2013), https://www.sec.gov/investment/fast-answers/divisionsinvestmentinvcoreg121504htm.html#P91_16908 [https://perma.cc/C3LG-P46K] (archived Aug. 22, 2018). Mutual funds offering sale of securities must also comply with the requirements of the Securities Act of 1933 (Securities Act). *Id.* For a more detailed description of the disclosure requirements for mutual funds, see U.S. SEC. & EXCH. COMM'N, FORM N-1A, https://www.sec.gov/files/formn-1a.pdf (last visited Sept. 4, 2018) [https://perma.cc/BG9X-WKZB] (archived Aug. 22, 2018) [hereinafter SEC FORM N-1A].

regulations; because there are no direct regulations governing their presentation, these disclosures are often more difficult to compare side-by-side. [160] Furthermore, while each index provider's classification system emphasizes the value of feedback from the "investment community," it appears as though the goals of each classification system are oriented towards meeting the needs of institutional investors, not individuals. [161] Although individual investors often invest through institutional investors that possess a great deal of information about index providers (e.g., mutual funds or pension funds), institutional investors are not required by law to provide any information about index providers to individual investors. This lack of transparency for individuals is problematic in light of index providers' growing role, especially coupled with the fact that individual investors do not appear to be involved in the country classification processes detailed in Part III.[162]

An investor in a mutual fund, whether the fund is actively or passively managed, receives a prospectus that contains detailed financial disclosures and may elect to receive more information mailed to their home.[163] The SEC also publishes information on its website, EDGAR, so that anyone—not just investors—has access to a fund's financial disclosures.[164] While information provided by index providers *is* publicly available, there are no regulatory constraints that determine how much information must be provided, and index providers' websites may be unclear and difficult to navigate.[165]

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160. Index providers often break down their indices into different sub-groups, and often list country classification processes under different parts of their websites (often labeled as "research" or "methodology"). See *supra* Part III for descriptions of leading index providers' country classification process.

161. FTSE's Country Classification Process is described as "a transparent and objective mechanism of classifying markets in a way that is designed to meet the ongoing needs of *institutional investors.*" *See* FTSE COUNTRY CLASSIFICATION, *supra* note 73 (emphasis added).

162. *See supra* Part III.

163. *See, e.g.*, *Information Available to Investment Company Shareholders*, U.S. SEC. & EXCH. COMM'N (Apr. 15, 2010), https://www.sec.gov/fast-answers/answersmfinfo htm.html [https://perma.cc/68XF-LEPY] (archived Aug. 22, 2018).

164. *See EDGAR Search Tools: Free Access to More Than 21 Million Filings*, U.S. SEC. & EXCH. COMM'N (May 31, 2012), https://www.sec.gov/edgar/searchedgar/webuser s.htm [https://perma.cc/N9GM-LHDE] (archived Aug. 22, 2018).

165. *See Market Indices*, *supra* note 11. Form N-1A, the form used by the SEC as a registration for open-ended investment companies (or mutual funds), requires disclosure of a fund's average annual total returns for 1 year, 5 years, and 10 years in comparison to an "appropriate broad-based securities index," but does not require any other information to be disclosed about the index. SEC FORM N-1A, *supra* note 159. Form N-1A defines "appropriate broad-based securities index" to mean one "that is administered by an organization that is not an affiliated person of the Fund, its investment adviser, or principal underwriter, unless the index is widely recognized and used." *Id.* Index funds are also required by Form N-1A to disclose their investment objectives and goals, but need not describe their underlying index in great detail. *See,*

Further, even if an investor finds the country classification summaries, actually understanding the disclosures put forth by index providers will likely require prior knowledge of financial terms or a willingness to research these terms on their own. In short, an investor must have the time and desire to weed through various methodology documents to access a summary of the country classification process. This is operating under the assumption that an investor even knows of the importance of said country classification process. If investors are either unaware or unlikely to seek out this information, it seems that there would be little incentive for index providers to tailor this information to be more accessible and transparent to them. An index provider's claim of transparency on their website may be enough for their information to pass muster.

Each country classification process suggests that institutional investors are the target audience for index providers, since each index provider explicitly mentions either meeting the needs of institutional investors, or soliciting institutional investors' feedback as a crucial part of their process.[166] Individual investors often invest in index funds through institutional investors, which suggests institutional investors may be at least indirectly acting with individual investors' interests in mind when they choose which index providers to do business with.[167]

However, it cannot be said that the information provided by index providers is truly transparent to the everyday investor. Since institutional investors are not required to disclose information about index providers, there is no guarantee that individuals know any other information about providers besides what is provided online. As noted previously, this may be lacking in information or difficult to find. Beyond the fact that investors may lack time, resources, or desire to seek out the information and digest it, investors also do not have access to the survey responses or feedback provided by institutional investors, nor does it appear they are able to serve on advisory boards or committees. They only know what index providers choose to put forth in press releases or what is disclosed in the forms required by the SEC, the Commodity Futures Trading Commission, or other regulatory bodies. Each index provider does not necessarily provide the information in the same way their peers do, perhaps

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e.g., THE VANGUARD GROUP, VANGUARD U.S. STOCK INDEX SMALL-CAPITALIZATION FUNDS PROSPECTUS 16 (Apr. 25, 2018), https://www.vanguard.com/pub/Pdf/p048.pdf [https://perma.cc/8QSA-4PAW] (archived Aug. 22, 2018) (listing an index fund's investment objective as tracking the performance of a benchmark index that measures the investment return of small-capitalization stocks).

166. *See* FTSE COUNTRY CLASSIFICATION, *supra* note 73 (describing FTSE's country classification process as meeting the "ongoing needs of institutional investors.")

167. *See What's the difference between institutional and non-institutional investors?*, INVESTOPEDIA (May 2018), https://www.investopedia.com/ask/answers/06/institutionalinvestor.asp [https://perma.cc/9RUC-ZGUH] (archived Aug. 6, 2018) (detailing the difference between institutional and non-institutional investors).

because of a desire to showcase the uniqueness of their own proprietary models. More problematically, investors may be unaware of negative feedback that index providers have chosen not to address. The lack of requirements for index providers differs greatly from the voluminous disclosure requirements required for index funds themselves. Not only must index funds comply with many different disclosure rules, the information provided must be written in "plain English" so investors may understand the disclosure more easily, and the disclosure is based off universal forms, allowing for easy comparison between products.[168] Without the benefit of a mandatory disclosure system, index providers have little incentive to provide an easy-to-digest, simple synopsis that is easily accessible.

In response to the 2012 LIBOR manipulation scandal, during which various financial institutions were investigated for their involvement in manipulating the benchmark interest rate based on the rates at which banks lend unsecured funds to each other on the London interbank market, the International Organization of Securities Commissions (IOSCO) promulgated the Principles for Financial Benchmarks (the Principles) in 2013.[169] The objective of the Principles was to create a framework for assessing principles of benchmarks used in financial markets.[170] The Principles encourage disclosure of compliance, and Dow Jones, MSCI, and FTSE have each publicly noted their compliance with the Principles in the years since their publication.[171] However, the compliance reports provided may

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168. Rule 421(d) of the Securities Act requires prospectuses to be written in "plain English." *See* 17 C.F.R. §§ 228, 229, 230, 239, 274 (1998) ("Full and fair disclosure is one of the cornerstones of investor protection under the federal securities laws. If a prospectus fails to communicate information clearly, investors do not receive that basic protection.").

169. For more information about the LIBOR scandal, see, for example, Chad Bray, *Libor Brought Scandal, Cost Billions—and May Be Going Away,* N.Y. TIMES (July 27, 2017) https://nyti.ms/2tMg6VL [https://perma.cc/SKL3-P5AC] (archived Aug. 6, 2018); James McBride, *Understanding the Libor Scandal,* COUNCIL ON FOREIGN RELATIONS (Oct. 12, 2016), https://www.cfr.org/backgrounder/understanding-libor-scandal [https://perma.cc/YMC4-2MNK] (archived Aug. 6, 2018); *Who Else is Under Fire for Libor Manipulation?,* WALL ST. J. (July 9, 2012, 12:21 PM), https://blogs.wsj.com/deals/2012/07/09/who-else-is-under-investigation-for-libor-manipulation/ [https://perma.cc/Q5DS-JSRL] (archived Aug. 6, 2018). For explanations of each IOSCO Principle, see IOSCO PRINCIPLES, *supra* note 18.

170. The overarching goals of the Principles are: overall responsibility of the administrator; oversight of third parties; conflict of interest for administrators; control framework for administrators; internal oversight; benchmark design; data sufficiency; hierarchy of data inputs; transparency of benchmark determinations; periodic review; content of the methodology; changes to the methodology; transition; submitter code of conduct; internal controls over data collection; complaints procedures; audits; audit trails; cooperation with regulatory authorities. *See* IOSCO PRINCIPLES, *supra* note 18.

171. Compliance, however, does not seem to imply full acceptance of each of the Principles. In a 2013 response to the Principles, MSCI stated that they would "strongly disagree that there is anything in the characteristics of the equity index industry that

not be very detailed, and it may be difficult for individuals to access compliance reports since they are not included on a central database like the SEC's EDGAR website.[172] Further, the framework created by the Principles is highly complex, and the fact that it was created in response to the LIBOR manipulation scandal suggests that it may be geared towards overall market manipulation rather than transparency for individual investors.[173] Additionally, while the Principles encourage compliance and suggest that regulatory action may be appropriate for certain types of benchmarks, there is still no formal regulatory oversight for index providers within the United States, raising the question as to whether the Principles have any effect on transparency for individual investors seeking to enter the

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should lead one to believe that it is in need of regulation to help ensure its credibility." *See* MSCI, MSCI RESPONSE TO THE IOSCO FINANCIAL BENCHMARKS CONSULTATION REPORT (Feb. 11, 2013), http://www.iosco.org/library/pubdocs/399/pdf/MSCI%20Inc.pdf [https://perma.cc/4PJN-UF2W] (archived Aug. 6, 2018).

172. Dow Jones issues a yearly press release announcing its compliance with the Principles; however, users wishing to review the examination conducted by independent accountants must navigate to Dow Jones's site, accept various terms and conditions (which include a waiver of any liabilities on the part of Dow Jones and a statement that compliance with the Principles is entirely voluntary) and provide their full name, email address, and reason for accessing the information. *See* Press Release, S&P Dow Jones Indices Completes its Fourth Annual Review of Adherence with IOSCO Principles for Financial Benchmarks, PR Newswire (July 13, 2017, 10:33 AM), https://www.prnewswire.com/news-releases/sp-dow-jones-indices-completes-its-fourth-annual-review-of-adherence-with-iosco-principles-for-financial-benchmarks-300487887.html [https://perma.cc/QLJ2-4ALF] (archived Aug. 6, 2018) [hereinafter Press Release, Fourth Annual Review]; *Governance,* S&P DOW JONES INDICES, http://us.spindices.com/governance/overview/ (last visited Sept. 4, 2018) [https://perma.cc/C6PK-XSPG] (archived Aug. 6, 2018) [hereinafter S&P *Governance*]. MSCI has a similar system to access its examination conducted by independent accountants. Users wishing to view the report must provide personal information, including their company, email address, and phone number. *See Index Regulation,* MSCI, https://www.msci.com/index-regulation (last visited Sept. 4, 2018) [https://perma.cc/P48Y-RXMC] (archived Aug. 6, 2018); MSCI, UPDATE TO MSCI'S COMPLIANCE STATEMENTS FOR THE IOSCO PRINCIPLES ON FINANCIAL BENCHMARKS (Dec. 2017), https://www.msci.com/documents/10199/3252826/MSCI+Equity+Indexes+-+IOSCO+Report+2016+-+11+July+2016.pdf [https://perma.cc/3PGG-FEAM] (archived Aug. 6, 2018) [hereinafter MSCI UPDATE]. In contrast, FTSE Russell's statement, which is audited by another accounting firm, is much easier to find and does not require a user to provide personal information in order to access it. *See* Press Release, FTSE Russell Confirms Compliance with IOSCO Principles, FTSE Russell (July 17, 2015), http://www.ftserussell.com/sites/default/files/press_releases/ftse_russell_confirms_compliance_with_iosco_principles_1358546_0.pdf [https://perma.cc/LF6W-6WYE] (archived Aug. 6, 2018) [hereinafter Press Release, Compliance]; *see also* FTSE RUSSELL, STATEMENT OF COMPLIANCE (July 2018).

173. The Principles emphasize the risks of manipulation in the future. *See* IOSCO PRINCIPLES, *supra* note 18 ("The IOSCO Board created the Task Force in light of investigations and enforcement actions regarding attempted manipulation of major interest rate Benchmarks. Those investigations and enforcement actions raised concerns over the fragility of certain Benchmarks – in terms of both their integrity and their continuity of provision – that has the potential to undermine market confidence potentially harming both investors and the real economy.").

market.[174] However, the Principles do explore another possible outcome due to lack of regulatory oversight: the possibility that index providers are subject to the same type of manipulation that occurred with respect to LIBOR. The next subpart of this Note will discuss the potential risk of market manipulation with respect to index providers.

B. *Market Manipulation*

The Principles were created in response to the 2012 LIBOR manipulation scandal.[175] Various financial institutions were investigated for their involvement in manipulating LIBOR, the benchmark interest rate based on the rates at which banks lend unsecured funds to each other on the London interbank market.[176] Because LIBOR is tied to so many loans throughout the world, the manipulation had disastrous effects for many investments.[177] In the wake of the manipulation scandal, management of LIBOR shifted from the private British Bankers' Association (BBA) to the ICE Benchmark Administration (IBA), an independent UK subsidiary of the private US-based exchange operator Intercontinental Exchange (ICE).[178] The results of these changes have been mixed.[179]

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174. *See id.* ("The majority of IOSCO members do not regulate Benchmark Administrators or Submitters. Nonetheless, IOSCO members should consider whether regulatory action (or recommendations for action by other relevant National Authorities in their own jurisdiction) may be appropriate to encourage implementation of the Principles.").

175. *See id.* ("The IOSCO Board created the Task Force in light of investigations and enforcement actions regarding attempted manipulation of major interest rate Benchmarks.").

176. *See, e.g.*, Bray, *supra* note 169; McBride, *supra* note 169; *Who Else is Under Fire for Libor Manipulation?*, *supra* note 169.

177. The one-year LIBOR, which represents the rate of interest on a loan between banks to be paid back within a year, is the most commonly used index for mortgages in the United States, according to the Consumer Financial Protection Bureau. *See* Bray, *supra* note 169.

178. McBride, *supra* note 169.

179. The outcome of the LIBOR scandal had mixed effects in terms of regulatory oversight and prosecution of the individuals involved. *See* Bray, *supra* note 169 ("Financial institutions, and individual bank employees, are still paying the price. Authorities on both sides of the Atlantic have pursued companies and bankers over Libor rigging, albeit with mixed success. The ensuing scandal also cost some senior bank executives, including the Barclays chief executive Robert E. Diamond Jr., their jobs."); *see also* Robert Peston, *Libor: The final humiliation for banks*, BBC NEWS (Sept. 28, 2012), http://www.bbc.com/news/business-19755863 [https://perma.cc/6H7W-93F5] (archived Aug. 6, 2018) ("The whole Libor-setting process will be firmly brought inside the regulatory net, so that the procedures followed by banks in submitting rates for the Libor calculations will be vetted by regulators and attempting to rig the rate will become an unambiguously illegal action."); *Tracking the Libor Scandal*, N.Y. TIMES DEALBOOK (Mar. 23, 2016), https://www.nytimes.com/interactive/2015/04/23/business/dealbook/db-libor-timeline.html#/#time370_10909 [https://perma.cc/A69P-WUYY]

The benchmarks created by index providers differ slightly from LIBOR. LIBOR was created by a panel of banks for the purpose of supporting other products offered by banks, such as loans and swaps.[180] In contrast, the indices created by index providers are the providers' primary business, and users are charged for the privilege of using them.[181] Needless to say, the rise of passive investing, particularly in index funds, has proven to be highly profitable for index providers.[182] Despite the differences between indices like LIBOR and the indices offered by index providers, both are subject to risks of market manipulation.[183] Manipulation of security prices is prohibited under the Securities Exchange Act of 1934 (Exchange Act), and usually refers to intentional conduct designed to deceive investors by controlling or artificially affecting the market for a security.[184]

The indices produced by index providers are produced through research and expertise, and, as previously noted, are not subject to regulation.[185] Prior to the manipulation scandal's emergence, banks and a private bankers' association maintained LIBOR; indices are similarly maintained by private entities, suggesting they may be similarly susceptible to manipulation since the research used by index providers is not necessarily wholly publicized.[186] In their article *Index Theory: The Law, Promise and Failure of Financial Indices*, Gabriel Rauterberg and Andrew Verstein provide an instructive example: S&P Global Platts (Platts), which provides benchmark prices and analytics for the energy and commodities markets, was accused of manipulating price quotes without detection

(archived Aug. 6, 2018) (describing various settlements and acquittals in connection with the LIBOR scandal).

180. *See* Rauterberg & Verstein, *supra* note 5, at 25–26.

181. *See id.*

182. *Id.* at 28 ("[E]stimates can be divined from MSCI, the only major index provider that makes regular public filings. If its financial information is any indication, then the indexing business is thriving. In 2010, MSCI made $350 million in revenue from index-type products. This represented a 52 percent increase in revenue from 2008. Revenues have increased largely because of an increase in the assets under management of subscribing funds. The ascendancy of indexed investing has been good for index providers and indexing is currently a high-margin business.").

183. *See id.* at 34–35.

184. *See Manipulation,* U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/fast-answers/answerstmanipulhtm.html (last visited Sept. 4, 2018) [https://perma.cc/3ZM4-CC25] (archived Aug. 6, 2018); *see also* 18 U.S.C. §§ 78(a), 9(a)(2).

185. Rauterberg and Verstein suggest that byproduct indices like LIBOR are more likely to be manipulated than product indices for three reasons: first, they tend to draw on privately available data, such as the bank's own funding information, whereas product indices, like the S&P 500, draw on public prices and therefore are harder to manipulate; second, byproduct indices do not themselves generate a large revenue stream, so index providers have comparatively less to lose by discrediting the index; and third, because byproduct indices are made alongside other product lines, their creators may experience conflicts of interest. *See* Rauterberg & Verstein, *supra* note 5, at 34–35.

186. *See id.* at 35.

in the 1930s in order to facilitate the collusive practices of oil companies.[187] A specific benchmark for an entire industry like Platts differs from the proprietary indices discussed in this Note. However, like Platts, today's indices produced by companies like MSCI, FTSE, and Dow Jones can all operate virtually out of the public eye, which suggests they may be similarly susceptible to price manipulation.

Another way in which an index may be susceptible to manipulation may be through its inclusion or omission of certain types of securities within a specific country or a sector. Consider, for example, the inclusion of China A-shares in emerging markets indices.[188] Unlike other types of Chinese securities, A-shares are typically not available for purchase by foreign investors.[189] Previously, MSCI's Emerging Markets Index contained broad exposure to Chinese securities, but MSCI decided to include A-shares as of this year, due to loosening of restrictions on pre-approval requirements for foreign investors and an expansion of China's Shanghai Stock Connect program into Shenzhen.[190] China already

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187. *Id.* at 35 ("The United States v. Socony-Vacuum Oil Co. case, a staple of antitrust casebooks, concerned oil companies conspiring to buy up distressed-price oil from the spot market that might have otherwise depressed the market price of their product. The plaintiffs alleged that Platts enabled the cartel by publishing false price data, allowing the oil companies to buy up the distressed oil at distressed prices but still inputting higher transaction prices when computing the market price. Without Platts's cooperation, the purchase of distressed-priced oil could have lowered the Platts price in a manner identical to how the oil would be sold on the open market. That would automatically lower the price paid by contracts indexed to Platts and indirectly lower the price buyers were willing to pay in the future. With Platts's alleged help, the manipulators could maintain an artificial price."). For general information about S&P Global Platts, see *About S&P Global Platts*, S&P GLOBAL PLATTS, https://www.platts.com/about (last visited Sept. 4, 2018) [https://perma.cc/KUU5-Z2M2] (archived Aug. 6, 2018).

188. For an explanation of China A-shares, see Brian Beers, *China vs. Hong Kong stock: Are H-shares and A-shares the same?*, INVESTOPEDIA, https://www.investopedia.com/ask/answers/062315/what-are-differences-between-hshares-and-ashares-chinese-and-hong-kong-stock-exchanges.asp (last visited Sept. 4, 2018) [https://perma.cc/4K36-HKQU] (archived Aug. 6, 2018).

189. *See id.* ("A-shares are shares of companies based in mainland China that are listed on either the Shanghai or Shenzhen stock exchanges. A-shares are generally only available for trading by mainland Chinese citizens. However, foreign investment in these companies is only allowed through a regulated structure known as the Qualified Foreign Institutional Investor System.").

190. Press Release, Results of MSCI 2017 Market Classification Review, MSCI (June 20, 2017), https://www.msci.com/eqb/pressreleases/archive/2017_Market_Classification_Announcement_Press_Release_FINAL.pdf [https://perma.cc/VX4F-QFZ5] (archived Aug. 6, 2018). The Shenzhen Connect Program was launched in December 2016, and allowed investors direct access to over a thousand Shanghai and Shenzhen stocks without needing to apply for a license and quota and capital restrictions. Shenzhen's exchange focuses heavily on tech, similar to the Nasdaq in the United States; whereas Shanghai's exchange is made up of largely blue-chip industrial companies and is more analogous to the New York Stock Exchange. *See* MSCI, CONSULTATION ON CHINA A-SHARES POTENTIAL INCLUSION (May 2017),

had a significant presence in the index through other types of securities, and the inclusion of A-shares would markedly increase this presence.[191] In a recent press release, MSCI described this decision as positively received by members of the institutional investor community.[192] Because this decision is so recent, it remains to be seen what the outcomes will be from the inclusion of China A-shares in the MSCI Emerging Markets Index.

Regardless of outcome, this example illustrates the idea that an index provider may pick and choose which types of stocks are included within a certain country's representation in an index. This can have a significant effect on the movement of the index. Furthermore, investors may not be aware that there is a difference between an index that has broad exposure to China and an index that has exposure to China that also includes China A-shares, unless they are looking specifically at the list of stocks within their fund's schedule of investments or the fund's prospectus.[193] This power to choose which specific stocks are included in an index can potentially lead to the index provider's manipulation of the index itself, creating a LIBOR-like scenario where the index performance may be under- or over-inflated depending on which types of stocks are actually part of the index. The China A-shares example also suggests that index providers may have the ability to affect public perception of a country's economic health and stability. This Note will describe this possibility in greater detail in the next subpart.

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https://www.msci.com/documents/1296102/ffd4f403-40c8-4821-a521-d74d7e4e1127 [https://perma.cc/D9LK-6FWV] (archived Aug. 6, 2018) [hereinafter MSCI CONSULTATION ON CHINA]; Neil Gough, *Shenzhen Connect Offers Chinese Stocks. Will the World Buy?*, N.Y. TIMES DEALBOOK (Nov. 25, 2016), https://www.nytimes.com/2016/11/25/business/dealbook/china-hongkong-shenzhen-connect.html [https://perma.cc/AP3W-Z6ZP] (archived Aug. 6, 2018).

191. *See, e.g.*, Chin Ping Chia, *A Look at MSCI's Emerging Markets Index and China A-Shares*, MSCI (Oct. 24, 2016), https://www.msci.com/www/blog-posts/a-look-at-msci-s-emerging/0390432641 [https://perma.cc/G96U-WRXE] (archived Aug. 6, 2018). In 2016, China A-Shares were rejected for inclusion in the Emerging Markets Index because of three obstacles: effective implementation of the qualified investor policy changes and removal of a 20 percent monthly repatriation limit; effective implementation of new trading suspension treatment; and resolution of pre-approval requirements by the local exchanges on launching financial products. *See* MSCI CONSULTATION ON CHINA, *supra* note 190. Certain factors were resolved and led to the inclusion of A-shares in 2017. *See* Press Release, Results of MSCI 2017 Market Classification Review, MSCI (June 20, 2017), https://www.msci.com/eqb/pressreleases/archive/2017_Market_Classification_Announcement_Press_Release_FINAL.pdf [https://perma.cc/JCC7-BLAS] (archived Aug. 6, 2018) [hereinafter Press Release, Market Classification].

192. Press Release, Market Classification, *supra* note 191.

193. For example, the Vanguard Emerging Markets Stock Index Fund tracks the FTSE Emerging Markets All Cap China A Inclusion Index, and lists investing in China A-shares as a specific risk for the fund. *See* THE VANGUARD GROUP, *supra* note 161.

C. *Changes to Economies for Countries Involved in Capital Allocation Decisions*

This Note has so far focused on index providers' reclassification of countries into frontier, emerging, and developed markets. These decisions inherently implicate capital allocation because investor decisions to invest in index funds affect where large amounts of capital will be directed.[194] Therefore, index providers make capital allocation decisions when they choose the makeup of their indices, including reclassifying countries into different categories for inclusion in certain indices.[195]

The DJIA provides a broad example of how an index provider's decision can have far-reaching effects. The DJIA is made up of thirty blue-chip stocks that are intended to be a representation of the American economy.[196] These stocks are chosen by a committee capable of making changes to the DJIA that may seem confusing to the public.[197] For example, in 1999, the DJIA committee added tech companies like Microsoft at the height of the tech bubble, and removed Chevron and Goodyear to make room, but then added Chevron back to the DJIA years later when its stock rose 60 percent.[198] The DJIA ostensibly represents a section of the American economy, and perhaps the movement of companies in and out of the DJIA does track the movement of the economy. The DJIA's methodology notes that, "while stock selection is not governed by quantitative rules, a stock typically is added to the index only if the company has an excellent reputation, demonstrates sustained growth and is of interest to a large number of investors."[199] Regardless of whether the committee's decisions are correct, it's clear that decisions

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194. *Capital Allocation*, INVESTOPEDIA, https://www.investopedia.com/terms/c/capital_allocation.asp (last visited Sept. 4, 2018) [https://perma.cc/RHU2-YLZP] (archived Aug. 6, 2018); *see also* Terence C. Burnham et al., *Investing in the Presence of Massive Flows: The Case of MSCI Country Reclassifications* 2 (Nat'l Bureau of Econ. Research, Working Paper No. 23557) ("The Indexes are used to allocate trillions of dollars in equities by thousands of proper indexers, active asset managers, pension funds, hedge funds, banks, and individuals around the world.").

195. For example, some indices may focus on one country's economy. *See, e.g.*, Press Release, Saudi Arabia Inclusion, *supra* note 17.

196. Adam Davidson, *Why Do We Still Care About the Dow?*, N.Y. TIMES MAG. (Feb. 8, 2012), http://www.nytimes.com/2012/02/12/magazine/dow-jones-problems.html [https://perma.cc/Y2LF-BXP8] (archived Aug. 6, 2018).

197. Henry Blodget, *How Dow Jones Wrecked the Dow Jones Industrial Average*, BUS. INSIDER (Apr. 4, 2009, 7:20 PM), http://www.businessinsider.com/henry-blodget-those-dow-people-sure-are-crappy-stockpickers-2009-4 [https://perma.cc/66UA-V6GN] (archived Aug. 6, 2018).

198. *Id.*

199. S&P DOW JONES INDICES, DOW JONES AVERAGES METHODOLOGY 5 (Apr. 2018), https://us.spindices.com/documents/methodologies/methodology-dj-averages.pdf [https://perma.cc/EM3A-5RT4] (archived Aug. 6, 2018).

about the companies that make up an index are being made by small groups of people who stand to receive financial benefits from their decisions.[200]

While other indices may not hold themselves out as representative of a broad swath of an economy, unlike the DJIA, they certainly make suggestions about different sectors of the market that have the opportunity to influence many people. In Part III, this Note explored the proprietary research models used for country classification.[201] The effects of a country's reclassification into either a frontier, emerging, or developed market index are far from abstract. An index provider's decision to include or exclude a country from its indices or to reclassify it into a different category can send many different signals to the market as a whole and has the potential to change a country's economy significantly.[202]

Saudi Arabia provides an instructive example since until very recently it was not included in any frontier, emerging, or developed markets indices. Prior to March 2018, all three of the index providers discussed in this Note had standalone indices that tracked the Saudi Arabian economy, but none included Saudi Arabia in their frontier, emerging, or developed markets indices.[203] This was not because Saudi Arabia's market is small or underdeveloped. In contrast, a factsheet for FTSE's standalone Saudi Arabia index notes that Saudi Arabia's equity market is the largest in the Middle East and the twenty-third largest in the world, yet it remains underinvested by

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200. Some have even compared the DJIA to an active fund, since its components are "handpicked, rather than being set using a rules-based process or some other kind of formula, as is the case with passive indexes." *See, e.g.*, Ryan Vlastelica, *Dow hitting 20,000 is a reminder that it's the best active fund ever fashioned,* MARKETWATCH (Jan. 26, 2017, 5:45 AM), https://www.marketwatch.com/story/the-dow-is-arguably-the-best-active-fund-ever-engineered-2016-12-22 [https://perma.cc/H949-J4L9] (archived Aug. 6 2018). A committee that includes editors of the Wall Street Journal, among others, chooses which companies make up the DJIA. *See* John A. Prestbo, *Secrets of the Dow Jones Industrials*, WALL ST. J. (May 8, 2016), https://www.wsj.com/articles/secrets-of-the-dow-jones-industrials-1462759211 [https://perma.cc/4RVT-YV7R] (archived Aug. 6, 2018).

201. *See supra* Part III.

202. *See* Alloway, Burger & Evans, *supra* note 14 ("In a market increasingly characterized by passive investing, these players can direct billions of dollars of investment flows by reclassifying a single country or company, effectively redrawing the borders of markets, shaping the norms of what's considered acceptable in international finance, and occasionally upsetting the travel plans of government ministers.").

203. *See* FTSE RUSSELL, FTSE SAUDI ARABIA INCLUSION INDEX SERIES (Oct. 2017), http://www.ftse.com/products/downloads/saudi-inclusion-faq.pdf [https://perma.cc/7HRV-HBMR] (archived Aug. 6, 2018) [hereinafter FTSE SAUDI ARABIA INCLUSION]; *MSCI Saudi Arabia IMI 25/50 Index,* MSCI, https://www.msci.com/documents/10199/7c8110d7-4adc-4116-aedd-933a590c2a23 [https://perma.cc/WQ6D-5LA9] (archived Aug. 6, 2018); *S&P Saudi Arabia,* S&P DOW JONES INDICES, https://us.spindices.com/indices/equity/sp-saudi-arabia-price-index-in-us-dollar (last visited Sept. 4, 2018) [https://perma.cc/MRK9-UWFE] (archived Aug. 6, 2018).

international investors due to various restrictions on foreign investments.[204] However, Saudi Arabia has recently taken steps to ease foreign ownership restrictions and amend its trading rules.[205] The country also piqued investors' interest earlier by announcing its decision to offer a percentage of stock in Saudi Aramco, its government-owned oil company, through an initial public offering.[206] The IPO was intended to serve as a funding source for Crown Prince Mohammed bin Salman bin Abdul-Aziz Al Saud's Vision 2030 plan.[207] Although the Aramco IPO was called off in August 2018, the country has suggested that it will pursue other methods of funding for the Vision 2030 plan, such as borrowing money through its private investment fund (PIF) or buying a large stake in Sabic, a publicly traded chemical company whose controlling shareholder is the PIF.[208] Regardless of whether the Aramco IPO takes place, these

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204. International investors previously could not invest in Saudi equities until the introduction of the Qualified Foreign Investor (QFI) scheme in 2015. In describing its reason for launching the index, FTSE noted Saudi Arabia's economic reforms, "Vision 2030" initiative, the rapid development and enhancement of market infrastructure, improved international investor access and potential future inclusion as an emerging market by global index providers. *See* FTSE SAUDI ARABIA INCLUSION, *supra* note 203; *see also* Matthew Martin & Felipe Pacheco, *Saudi Bourse Takes More Steps to Bolster Emerging Markets Case,* BLOOMBERG (Jan. 10, 2018, 10:03 PM), https://www.bloomberg.com/news/articles/2018-01-10/saudi-bourse-takes-more-steps-to-bolster-emerging-markets-case [https://perma.cc/7MY5-BCWF] (archived Aug. 6, 2018). The "Vision 2030" initiative refers to Saudi Arabia's desire to diversify its economic growth, build a high-performing and efficient government, and protect its cultural heritage. The Vision 2030 initiative discusses a number of programs and is centered on three themes: a vibrant society, a thriving economy, and an ambitious nation. *See* VISION 2030, KINGDOM OF SAUDI ARABIA, http://vision2030.gov.sa/sites/default/files/report/Saudi_Vision2030_EN_2017.pdf [https://perma.cc/239R-XZKK] (archived Aug. 6, 2018).

205. *See* Martin & Pacheco, *supra* note 204.

206. Aramco is currently valued at roughly USD $1.5 trillion, which is almost twice that of Apple Inc., four times bigger than Exxon Mobil Co., and at least one-fifth of the USD $5.8 trillion MSCI Emerging Markets Index, the benchmark for emerging markets, according to data compiled by Bloomberg. At the same time, Saudi Arabia plans to create the largest sovereign wealth fund and sell hundreds of state assets, including stakes in the stock exchange, football clubs and flourmills. *See* Matthew Winkler, Felipe Pacheco & Shin Pei, *How a $1.5 Trillion Aramco IPO Could Transform Global Stocks,* BLOOMBERG (Jan. 25, 2018, 11:47 PM), https://www.bloomberg.com/news/articles/2018-01-25/aramco-seen-transforming-global-stocks-with-1-5-trillion-value [https://perma.cc/PWA4-GFPY] (last visited Aug. 6, 2018).

207. *Id.*

208. Reports have suggested that the IPO is being postponed until after the Sabic acquisition. *See* Michael J. de la Merced, *No Saudi Aramco I.P.O.? No Problem, Potentially, for Saudi Arabia's Investment Dreams,* N.Y. TIMES DEALBOOK (Aug. 24, 2018), https://www.nytimes.com/2018/08/24/business/dealbook/saudi-arabia-aramco-ipo.html [https://perma.cc/T74F-7J77] (archived Oct. 5, 2018); Michael J. de la Merced & Clifford Krauss, *Saudi Aramco Is Said to Postpone Its Potentially Record-Breaking I.P.O.,* N.Y. TIMES DEALBOOK (Aug. 22, 2018), https://www.nytimes.com/2018/08/22/bus

decisions showcase Saudi Arabia's desire to attract more capital inflows and foreign investors.

Saudi Arabia's willingness to modify its trading rules was a catalyst for index providers to reconsider their investments in the country. In 2017, FTSE placed Saudi Arabia on its "Watch List," and in 2018, FTSE announced that Saudi Arabia would be part of its emerging market index starting in March 2019.[209] MSCI also noted in its 2017 annual country classification that it would launch a consultation regarding the potential inclusion of Saudi Arabia in its Emerging Markets index.[210] In June 2018, MSCI announced that Saudi Arabia would be included in its emerging markets index, beginning in June 2019.[211] Both providers cited recent reforms by Prince Mohammed and efforts to open Tadawul (the Saudi stock

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iness/dealbook/saudi-aramco-ipo.html?module=Uisil [https://perma.cc/GT6S-95VF] (archived Oct. 5, 2018) ("Buying part of Sabic, a giant in its own right, could make Saudi Aramco a more valuable company while the petrochemical industry is growing around the world. That, in turn, could help the oil company draw even more interest in a public offering."). The Saudi government has denied reports that the Aramco IPO is cancelled, but has not spoken to the Sabic acquisition specifically. *See Saudi energy minister says Aramco IPO still on, refutes media reports indicating otherwise*, ARAB NEWS (Aug. 23, 2018), http://www.arabnews.com/node/1360691/saudi-arabia [https://perma.cc/GY5D-U4Z5] (archived Oct. 5, 2018) ("The Government remains committed to the IPO of Saudi Aramco at a time of its own choosing when conditions are optimum. This timing will depend on multiple factors, including favorable market conditions, and a downstream acquisition which the Company will pursue in the next few months, as directed by its Board of Directors.").

209. *See* FTSE RUSSELL, SAUDI ARABIA RECLASSIFICATION (Mar. 2018), http://www.ftserussell.com/files/research/saudi-arabia-reclassification [https://perma.cc/7AUL-RT92] (archived Oct. 5, 2018) [hereinafter FTSE SAUDI ARABIA RECLASSIFICATION]. FTSE Russell announced the classification of Saudi Arabia as a Secondary Emerging market within the FTSE Global Equity Index Series (GEIS) on March 28, 2018, as part of the Country Classification Interim Update. The Kingdom's entry into the international equity markets marks a major milestone in its quest to grow and diversify its economy. *Id.*; *see also* FTSE SAUDI ARABIA INCLUSION, *supra* note 203.

210. Inclusion of Saudi Arabia in both the FTSE and MSCI EM indices by the end of 2018 would be a "key milestone for the region's capital markets," according to Bassel Khatoun, CEO of Middle East North Africa equities for Franklin Templeton. Khatoun noted that "inclusion in the MSCI EM, for example, would be a transformative catalyst, not just for Saudi Arabia's stock market, but for exchanges throughout the entire region helping eliminate what we have always viewed as a material disconnect between the GDP contribution of this region and its representation in MSCI EM." Felipe Pacheco, *Saudi Arabia Still Poised for EM Inclusion, Franklin Says*, BLOOMBERG (Oct. 2, 2017, 3:41 AM), https://www.bloomberg.com/news/articles/2017-10-02/saudi-arabia-still-poised-for-em-inclusion-2018-franklin-says [https://perma.cc/WC3H-B7XU] (archived Aug. 6, 2018).

211. MSCI noted that the decision to include the Saudi Arabia Index in its emerging market index "follows the implementation in the Saudi Arabia equity market of a number of regulatory and operational enhancements which effectively increased the opening of the market to international institutional investors." MSCI, RESULTS OF MSCI 2018 MARKET CLASSIFICATION REVIEW (June 2018), https://www.msci.com/documents/10199/238444/RESULTS_OF_MSCI_2018_MARKET_CLASSIFICATION_REVIEW_%28FINAL%29.pdf/95fa3628-ff2e-e9cd-53b9-8912329ec40c [https://perma.cc/ZC3U-YW8K] (archived Oct. 5, 2018) [hereinafter 2018 MSCI CLASSIFICATION].

exchange) to foreign investors, as well as the Aramco IPO, as reasons for the country's inclusion in the indices.[212]

Inclusion in FTSE and MSCI's indices will likely have far-reaching effects on Saudi Arabia.[213] Countries that meet certain criteria for the index providers' classification systems can often expect an injection of capital and a jump in volumes traded on their markets.[214] In Saudi Arabia's case, the country bypasses "frontier" status completely, signaling to investors that its economy is highly valued.[215] Beyond showing the strength of the Saudi Arabian economy, inclusion in emerging markets indices exposes Saudi Arabia

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212. *See* FTSE SAUDI ARABIA RECLASSIFICATION, *supra* note 209 ("The Saudi government has prioritized the opening of its capital markets to foreign investment as a critical part of its long-term efforts to grow and diversity its economy ... In its early stages, Saudi Arabia's new registration process presented a high bar for participation, hindering foreign capital inflows. But Saudi policymakers moved quickly to make the market more foreign-investor friendly and aligned with the views and practices of the international investment community."); 2018 MSCI CLASSIFICATION, *supra* note 211 ("International investors were impressed by the speed of change in the accessibility of the Saudi Arabian equity market and the level of commitment that the Capital Market Authority (CMA) and the Saudi Stock Exchange (Tadawul) have demonstrated.").

213. *See, e.g.*, Felipe Pacheco & Matthew Martin, *Saudi Arabia Wins Coveted Emerging-Market Status in MSCI Upgrade,* BLOOMBERG (June 20, 2018), https://www.bloomberg.com/news/articles/2018-06-20/saudi-arabia-wins-coveted-emerging-market-status-in-msci-upgrade ("Analysts estimate MSCI's decision on Saudi Arabia will lead to billions of dollars from money managers worldwide and help improve liquidity in the biggest stock market in the Middle East and Africa."); Andrew Torchia & David French, *Saudi to join FTSE emerging index from next March, attract billions,* REUTERS (Mar. 28, 2018, 4:04 PM), https://uk.reuters.com/article/uk-saudi-stocks-ftse/saudi-to-join-ftse-emerging-index-from-next-march-attract-billions-idUKKBN1H436U [https://perma.cc/C9GG-SU6T] (archived Oct. 5, 2018) ("All told, Saudi Arabia could see a total of $30 billion to $45 billion of inflows in the next two years if it reaches the foreign ownership levels of markets in the neighbouring United Arab Emirates and Qatar.").

214. The creation of FTSE's standalone indices was seen as an endorsement by a "respected international investment organization of the modernization program undertaken by the Saudi Capital Markets Authority and by the Tadawul, the Riyadh stock exchange." *See* Frank Kane, *Saudi Arabia's stock market to get major boost from FTSE index inclusion,* ARAB NEWS (Oct. 29, 2017, 2:46 PM), http://www.arabnews.com/node/1184951/business-economy [https://perma.cc/YD2K-FKCK] (archived Aug. 6, 2018) ("In a major boost to the Saudi Arabian stock market, the Kingdom is to be included in a series of global indexes investors use to guide decisions on where to put billions of dollars' worth of funds."). Kuwait was recently classified as secondary emerging for FTSE, a "classification likely to generate as much as $600 million of inflows to the smaller Gulf state." *See* Martin & Pacheco, *supra* note 204.

215. *See* FTSE SAUDI ARABIA RECLASSIFICATION, *supra* note 209 ("With a gross national income per capita of around US$22,000, the Kingdom is also classified as a high-income economy by the World Bank, placing it above most of its emerging-market peers."). *See also* Alloway, Burger & Evans, *supra* note 14 ("If included, the kingdom would essentially leapfrog frontier-market status and head straight into the bigger and broader emerging-markets bucket, enjoying an estimated $4 billion of flows from new investors along the way.").

to a larger pool of investors than if it were included in a frontier markets index.[216] Additionally, a decision to include Saudi Arabia in an index also allows the country to benefit from large capital inflows and provides a more direct route to foreign ownership.[217] For example, inclusion in FTSE Russell's index could lead to approximately USD $4.4 billion in flows to Tadawul.[218] The example of Saudi Arabia is illustrative of what can happen for many countries: inclusion in an index can open various doors for a country, and presents a valuable opportunity to gain exposure to foreign markets. Conversely, there can be far-reaching negative effects when a country is bypassed for inclusion in an index.

The debate about which countries to include and which to exclude puts a great deal of power into index providers' hands. This fact does not seem to be lost on financial representatives of the countries. Beyond modifying their trading rules and promoting investment in their markets, countries are likely to pander to the index providers and the greater "investment community." The CEO of Tadawul, Khalid Abdullah Al Hussan, noted that Tadawul was "very aggressive in the means of reaching international investors and educating them about these changes, making sure all changes [were] understood."[219]

Greater levels of communication may be a positive attribute within the investment world. However, when many of the decisions are made behind closed doors by a small handful of people that are not subject to regulation, it begs the question as to whether this is the type of communication that investors may prefer. A change in country classification can indeed have far-reaching effects. Perhaps it is in individual investors' best interest to move any conversations between countries, index providers, and institutional investors out into the open. After all, a country's inclusion or exclusion from an index not only affects those that work within the investment community, but also investors as a whole. Citizens benefit when a country is seen as

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216. *See* Alloway, Burger & Evans, supra note 14.

217. *See id.* ("That would be a win for a Saudi bourse that has had little to show after two years of regulatory efforts to attract foreigners, seeking the stability of more institutional money for an exchange driven by local individuals' trading. Total foreign ownership is below 5 percent, according to data on the Tadawul exchange's website.").

218. *See* Sarmad Khan, *Saudi Arabia left out of FTSE Russell emerging markets index, Kuwait Upgraded,* THE NATIONAL (Sept. 30, 2017 8:16 PM), https://www.thenational.ae/business/markets/saudi-arabia-left-out-of-ftse-russell-emerging-markets-index-kuwait-upgraded-1.662966 [https://perma.cc/J5EN-PBJF] (archived Aug. 6, 2018). The Tadawul is the largest stock exchange in the Middle East, but its market capitalization (roughly USD $500 billion) is still much smaller than that of the largest stock exchanges. *See* Michael Ovaska & Asa Fitch, *Saudi Arabia in the Spotlight as Stock Market Opens to Foreigners,* WALL ST. J. (June 12, 2015, 2:00 PM), http://graphics.wsj.com/saudi-stock-market-to-open/ [https://perma.cc/C7XX-EGDZ] (archived Aug. 6, 2018).

219. *See* Martin & Pacheco, *supra* note 204.

having a strong economy, and they likely suffer when an economy is expected to be in decline. Yet it appears individual investors and everyday people take no part in these discussions, which is highly problematic. In Part V, this Note will provide a suggestion for a regulatory framework that would better address these issues.

V. CREATING A REGULATORY FRAMEWORK WITHIN THE UNITED STATES

Index providers currently have a large amount of discretion to choose the makeup of their indices, whether through selecting blue-chip companies or reclassifying different countries. This lack of oversight has the potential to lead to a lack of transparency for investors, the possibility of market manipulation, and negative effects on countries' economies. On an international level, both IOSCO and the European Securities and Market Authority (ESMA) enacted regulatory frameworks that address many of these issues.[220] For consistency across the global financial markets, regulators in the United States should seek to replicate many of the underlying concepts of the Principles and the recent ESMA regulation. However, requiring index providers to adhere to the same complex regulatory scheme adopted by ESMA is not necessarily the ideal solution for US securities markets.

This Note proposes that in order to alleviate the concerns described in Part IV, index providers should be required to register with the SEC, and then to participate in notice-and-comment rulemaking when they either propose new rules or make changes to their existing rules. This process would be analogous to the current requirements for credit rating agencies under the Exchange Act, and would help alleviate many of the concerns outlined in this Note.

A. *Existing Regulatory Frameworks*

Part IV.A of this Note discussed the IOSCO Principles on Financial Benchmarks, which were promulgated by the International Organization of Securities Commissions.[221] IOSCO is an international body that brings together the world's securities regulators and develops, implements, and promotes adherence to internationally recognized standards for securities regulation.[222] In April 2013, IOSCO produced a consultation report on principles for

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220. *See* IOSCO PRINCIPLES, *supra* note 18; *Benchmarks*, *supra* note 18.

221. *See supra* Part IV.A.

222. *About IOSCO,* INT'L ORG. SEC. COMM'NS, https://www.iosco.org/about/?subsection=about_iosco (last visited Sept. 4, 2018) [https://perma.cc/KK4L-MZ8B] (archived Aug. 6, 2018).

financial benchmarks, which requested comments from the public on the proposed Principles.[223] In compiling the Principles, IOSCO also considered earlier public comments and comments at stakeholder meetings, as well as research compiled by other members of the financial industry.[224] The Principles are viewed as recommended practice for the worldwide financial industry, and are not legally binding.[225]

ESMA is an independent EU authority whose purpose is to improve investor protection and to promote stable and orderly financial markets.[226] ESMA published the EU Benchmarks Regulation (BMR) in June 2016, with most rules taking effect January 1, 2018.[227] Unlike the Principles, which serve as a set of guidelines, the BMR is legally binding on members of the EU.[228] Some of the BMR's key provisions include requiring EU administrators of a broad class of benchmarks to be authorized or registered by a national regulator, and for these administrators to implement various governance systems and other controls to ensure the integrity and reliability of their benchmarks.[229] Administrators that provide critical and significant benchmarks, as well as commodity and interest rate benchmarks, must submit an application to a relevant authority.[230] In all other cases, registration with the

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223. IOSCO PRINCIPLES, *supra* note 18.

224. *Id.*

225. Dee Ruddy, *IOSCO's guidance on statements of compliance with the IOSCO Principles on Financial Benchmarks,* KPMG FUND NEWS, (Dec. 16, 2016), http://www.kpmgfundnews.eu/international/2016/12/ioscos-guidance-statements-compliance-iosco-principles-financial-benchmarks/ [https://perma.cc/8P37-59NF] (archived Aug. 6, 2018).

226. ESMA has three objectives: investor protection—to make sure that financial consumers' needs are better served and to strengthen their rights as investors, while also acknowledging their responsibilities; orderly markets—to promote the integrity, transparency, efficiency and proper functioning of financial markets and robust market infrastructure; and financial stability—to strengthen the financial system so it can withstand shocks and the unraveling of financial imbalances, and to encourage economic growth. *See The European Securities and Market Authority,* EUROPEAN UNION, https://europa.eu/european-union/about-eu/agencies/esma_en (last visited Sept. 4, 2018) [https://perma.cc/XU5G-JMSV] (archived Aug. 6, 2018).

227. *Benchmarks, supra* note 18.

228. *Id.*

229. The requirements of the BMR build on the 2013 Principles for Financial Benchmarks and the 2012 Principles for Oil Price Reporting Agencies adopted by IOSCO. CHRISTOPHER BATES, CLIFFORD CHANCE, THE NEW EU BENCHMARKS REGULATION—WHAT YOU NEED TO KNOW (Sept. 7, 2016), https://www.cliffordchance.com/briefings/2016/09/the_new_eu_benchmarksregulationwhatyounee.html [https://perma.cc/4UXX-MRTL] (archived Oct. 5, 2018).

230. A critical benchmark is defined as a benchmark where the value of the underlying contracts is at least 500 billion euros, or that is recognized as critical in a member state. A significant benchmark is defined as a benchmark where the value of underlying contracts is at least 50 billion euros, or where there are either none or very few market-led substitutes, leading to a significant impact on financial stability if the benchmark ceases production. Critical benchmarks are also subject to greater

designated authority is sufficient.[231] Administrators are also required to provide a code of conduct specifying requirements and responsibilities regarding input data.[232] The BMR also affects the United States because US-based administrators are subject to its rules if they intend to obtain EU market access.[233] Thus far, it is unclear how successful the BMR has been since most of its provisions only went into force in January 2018. Regardless, the BMR presents an ambitious move towards regulating the benchmarks industry after the LIBOR scandal.

B. *Proposal for Analogous Regulations in the United States*

Although the BMR affects US-based index providers that wish to register their products in the EU, it does not have any effect on index providers' continued business in the United States. As stated in Part IV.A, many index providers have published notice of their compliance with the Principles.[234] However, the Principles are not legally binding and do not require index providers to register or apply for regulation under a certain authority like the BMR does. Additionally, since index providers' statements of compliance are voluntary and do not require any specific disclosures, it is unclear to what extent they actually provide more investor transparency and clarity. For instance, MSCI's compliance statement as of December 2017 states that it established a committee and clarified terms to avoid confusion with defined terms within the BMR; however, it is unclear if investor feedback was taken into consideration when making any of these changes.[235] Perhaps if index providers are required to register with ESMA in order to conduct business in the EU, this will lead to

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requirements, including a mandatory annual external audit of compliance; a regulators' power to delay the discontinuance of the benchmark by requiring the administrator temporarily to continue the provision of the benchmark; provision of licenses of and information on the benchmark by the administrator; temporary contributions of input data to the benchmark; and establishing a college of supervisors to oversee the benchmark within the administrator's home state. *See, e.g.*, *id.*; Martin Liebl & Alexandra Balmer, *EU Financial Market Benchmark Regulation and US Impact,* HARV. L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (Nov. 1, 2017), https://corpgov.law.harvard.edu/2017/11/01/eu-financial-market-benchmark-regulation-and-us-impact/ [https://perma.cc/MT5T-YUUV] (archived Aug. 6, 2018).

231. Liebl & Balmer, *supra* note 230. Authorization and registration are described within the BMR as "distinct processes with authorization requiring a more extensive assessment of the administrator's application." Regulation 2016/1011 of the European Parliament and of the Council of 8 June 2016, 2016 O.J. (L 171) 43.

232. Liebl & Balmer, *supra* note 230.

233. US administrators can become compliant with BMR through equivalence, recognition, or endorsement. For an in-depth description of each process, see *id.*; see also BATES, *supra* note 229.

234. *See* MSCI UPDATE, *supra* note 172; Press Release, Fourth Annual Review, *supra* note 172; Press Release, Compliance, *supra* note 172.

235. MSCI UPDATE, *supra* note 172.

greater transparency surrounding their behaviors when conducting business in the United States. However, in order to encourage full disclosure, it is necessary to implement a system for index providers that want to continue providing services in the United States. This system should be tailored more specifically to the United States' securities laws and should be designed to encourage transparent disclosure of changes to rules, rather than simply requiring registration or authorization like the BMR. Additionally, any analogous system in the United States to the BMR need not be drawn as broadly, since the main focus is on regulating product index providers, rather than indices like LIBOR.[236]

Regulations for credit rating agencies and nationally recognized statistical rating organizations (NRSROs) can provide an instructive analogy for potential regulations for index providers.[237] Credit ratings agencies were initially regulated under the Credit Rating Agency Reform Act of 2006, but after the financial crisis of 2008, more stringent regulations were passed as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank).[238] This was in response to beliefs that credit rating agencies' inflated ratings played a key role in the market collapse; since credit rating agencies are paid by issuers to provide ratings, conflicts of interest naturally arise in their businesses.[239] The Credit Rating

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236. *See* Andrew Sulston, *Benchmark compliance shifts up a gear: The EU Benchmarks Regulation enters into force*, ALLEN & OVERY, http://www.allenovery.com/publications/engb/lrrfs/continental%20europe/Pages/Benchmark-compliance-shifts-up-a-gear-the-EU-Benchmarks-Regulation-enters-into-force.aspx (last visited Sept. 4, 2018) [https://perma.cc/AY9Z-S96C] (archived Aug. 6, 2018) ("The definition of a benchmark is widely drawn. It will capture many levels not traditionally thought of as a benchmark, including potentially many index levels, portfolio levels and basket levels, as well as some reported prices that the market relies on from different data providers.").

237. *Credit Ratings Agencies and Nationally Recognized Statistical Organizations (NSROs)*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/fast-answers/answersnrsrohtm.html (last visited Sept. 4, 2018) [https://perma.cc/NXS8-QF2E] (archived Aug. 6, 2018) ("A credit rating agency assesses the creditworthiness of an obligor as an entity or with respect to specific securities or money market instruments. A credit rating agency may apply to the SEC for registration as a nationally recognized statistical rating organization ('NRSRO')."). For descriptions of credit ratings, see MOODY'S INVESTORS SERV., *supra* note 103; *Ratings Definitions*, *supra* note 103; *S&P Global Ratings Definitions*, *supra* note 103.

238. *Credit Rating Agencies*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/spotlight/dodd-frank/creditratingagencies.shtml [https://perma.cc/5X2Y-XN2K] (archived Aug. 6, 2018) (providing a history of credit rating agency rules and regulations).

239. *See, e.g.*, EDWARD I. ALTMAN ET AL., REGULATION OF RATING AGENCIES, CREDIT MARKETS 443 (2010) ("It has been widely argued that the rating agencies played a central role as enablers in the financial crisis of 2007 to 2009, due to the following two key features of the ratings process."); David Dayen, *Remember This Moment When the Next Financial Crisis Strikes*, THE NEW REPUBLIC (Aug. 28, 2014), https://newrepublic.com/article/119256/rating-agency-regulations-why-secs-new-rules-wont-fix-them [https://perma.cc/2FJ8-U3EK] (archived Aug. 25, 2018) ("Credit rating agencies were the drivers of the financial crisis. Their AAA stamps of approval

Agency Reform Act outlined reasons for regulating credit rating agencies, modified § 3(a) of the Exchange Act to include definitions for credit ratings, and added § 15(e), which describes the registration process for NRSROs.[240] Dodd-Frank added to the original registration process and requirements in a number of ways, including: requiring the SEC and the Government Accountability Office to study NRSROs' "issuer-pays" model and to propose a different business model; reducing NRSROs' official roles in certain transactions; increasing their legal liability; and expanding the SEC's regulatory power over NRSROs.[241]

Arguably, many of the concerns described in the Credit Rating Agency Reform Act and Dodd-Frank overlap with the concerns outlined in this Note. This Note proposes that the SEC adopt a similar system for the regulation of index providers. Much like credit rating agencies, a few large index providers dominate the industry.[242] There is perhaps a stronger conflict of interest between an issuer and a credit rating agency that is being paid by said issuer than between individual companies and countries that wish to be included in an index. However, there are still incentives for index providers to act in ways that do not benefit investors as a whole.[243] Many of the reasons for regulating credit rating agencies, described by Congress in the

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encouraged investors to purchase massive quantities of subprime mortgage-backed securities. As we now know, these assurances of complete safety led investors right into a toxic meltdown. This was entirely foreseeable: Rating agencies get paid to rate securities by the companies who issue them. This places an inherent conflict of interest at the heart of their business model: If they make it easier for a client to sell questionable securities by rating them highly, then that client will return with future business."); Alice M. Rivlin & John B. Soroushian, *Credit rating agency reform is incomplete,* BROOKINGS (Mar. 6, 2017), https://www.brookings.edu/research/credit-rating-agency-reform-is-incomplete/ [https://perma.cc/MK8X-TT4X] (archived Aug. 6, 2018) ("Their overoptimistic ratings of structured mortgage products helped inflate the housing bubble. Inflated ratings helped channel capital into the riskier parts of the mortgage sector and helped create the large mortgage debt overhang that has slowed economic growth post-crisis. These overoptimistic ratings also allowed financial institutions to take on more risk than regulators intended by investing in high yielding AAA and investment grade structured mortgage products.").

240. The Act requires each potential NSRSO to fill out an application that includes their policies, codes of ethics, procedures and methodologies, 20 largest issuers and subscribers, and other key information about each credit ratings agency. Potential NSRSOs must also provide written accreditations from 10 unaffiliated institutional buyers. Credit Rating Agency Reform Act of 2006, Pub. L. No. 109–291, 120 Stat. 1327 (2006).

241. According to some, the reforms described in Dodd-Frank have not necessarily been a success. For instance, the SEC has not proposed legal liability rules, nor have they endorsed a business model for NSRSOs (or implemented a random assignment procedure, as described in Dodd-Frank). *See* Rivlin & Soroushian, *supra* note 239.

242. *See supra* Part III for descriptions of major index providers.

243. *See supra* Part IV for descriptions of risks and outcomes.

Credit Rating Agency Reform Act, also apply to index providers.[244] If index providers were required to register with the SEC, the process of index selection would become more transparent and would reduce the risk factors outlined in this Note.

However, index providers should also be required to engage in public notice-and-comment periods when modifying their internal rules and methodologies. This requirement would further address many of the issues discussed in this Note. Requiring public notice-and-comment periods would disclose the substance of specific changes made to index providers' rules and regulations, rather than merely subjecting index providers to SEC oversight. Additionally, this rule would eliminate the distinctions between critical or significant benchmarks described in the BMR, which would provide for consistency and comparison. However, this would require index providers to compile internal rules, and to provide these rules online for investors to consider.[245] Most index providers already have internal guidelines on their websites; the challenge would be presenting these rules in the most transparent and accessible way.[246]

Imposing new regulatory instructions on index providers—whether they include registering with the SEC, providing internal rules, or publishing additions and/or changes to those rules for notice-and-comment—may lead to pushback from index providers. However, any index provider that conducts business in the EU must undergo a registration or application process under the BMR, as described in Part V.A.[247] If index providers must be ready to provide information to comply with the BMR's requirements, providing additional information to the SEC would only be a small hurdle.

Additionally, the emergence of the BMR and the Principles within the last five years suggests that there may be some consensus, at least on the international level, that index providers ought to be regulated in some way. Requiring index providers to engage in notice-

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244. Some of the reasons for regulating credit ratings agencies included the fact that their ratings, publications, writings, analyses, etc., implicated the mail and other means and instrumentalities of interstate commerce; these ratings related to the purchase and sale of securities on exchanges; the volume of these transactions; compelling interest in investor protection; the need for additional competition (since at the time, only 2 credit ratings agencies served the majority of the market); and the SEC's desire to oversee the industry. *See* Credit Rating Agency Reform Act.

245. *See The Nasdaq Stock Market Rules*, NASDAQ, http://nasdaq.cchwallstreet.com/ (last visited Sept. 4, 2018) [https://perma.cc/3K9E-EX7B] (archived Aug. 6, 2018).

246. *See, e.g.*, *Corporate Governance*, MSCI, http://ir.msci.com/corporate-governance.cfm (last visited Aug. 6, 2018) [https://perma.cc/66E5-UJ2A] (archived Aug. 6, 2018) [hereinafter MSCI *Corporate Governance*]; *Governance*, FTSE RUSSELL, http://www.ftse.com/products/indices/governance?_ga=2.152858810.201305055.1519760929-1151463201.1517805653 (last visited Aug. 6, 2018) [https://perma.cc/P3EN-RU9B] (archived Aug. 6, 2018) [hereinafter FTSE RUSSELL *Governance*]; S&P *Governance*, *supra* note 172.

247. *See supra* Part V.A.

and-comment periods would also be mutually beneficial since the country classification systems outlined in Part III all mention soliciting feedback from the investment community at large.[248] If index providers are already spending time and money to solicit feedback from others, moving this solicitation of feedback to a more public setting would further benefit the investment community since the questions and responses would be available for all to read. Moreover, if institutional investors are indeed the focus of index providers' surveys, they may be more likely to engage in public commenting than individual investors; the greater benefit is that individuals may read the responses if they so desire, even if they do not wish to comment. Aggregating index providers' surveys in a public forum through notice-and-comment would also provide a centralized location for investors to easily compare responses between different providers. Finally, it would send a message to the investment community as a whole that index providers care about providing transparent and easily accessible information about their products.

With regards to developing internal rules, many index providers may have sets of governance documents or information about their methodology already present on their websites.[249] However, providing transparency to investors does not require index providers to disclose the proprietary nature of their models; the Principles specifically address this point in a section that discusses feedback from the initial consultation report.[250] Index providers should make these rules more easily accessible on their websites, and the SEC should produce guidance and/or a form suggesting key internal rules for index providers to develop. Consistency across index providers' internal rules would also facilitate greater transparency since investors would be able to easily spot differences within providers' methodologies in the same way that investors can easily compare funds' mandatory disclosures.

This solution may be costly for financial regulators and index providers, but the SEC should strive to develop a rigorous regulatory framework for index providers within the United States, especially given the influence that the BMR is likely to have on global financial markets. The implementation of this system could be rolled out over

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248. *See* FTSE COUNTRY CLASSIFICATION, *supra* note 73; MSCI GLOBAL INDEXES, *supra* note 118; S&P COUNTRY CLASSIFICATION, *supra* note 93.

249. *See, e.g.*, FTSE RUSSELL *Governance*, *supra* note 246; MSCI *Corporate Governance*, *supra* note 246; S&P *Governance*, *supra* note 172.

250. IOSCO PRINCIPLES, *supra* note 18 ("Principles 4, 5 and 12 have therefore been amended to make clear that transparency to Stakeholders *does not mean full disclosure of proprietary information.* In particular, summary information and key features may be disclosed to Stakeholders to comply with these Principles.") (emphasis added).

time. The SEC could first begin by publishing guidance, analogous to the Principles, that suggests information that index providers should provide in their internal rules. Amending the Exchange Act to reflect a system of registration analogous to the registration currently in place for credit-rating agencies would then follow. The notice-and-comment requirements would shift the burden of filing new rules and changes to existing rules onto the index providers themselves. Regardless of how this system is implemented, it has the potential to protect investors and maintain a transparent and efficient market.

VI. CONCLUSION

Passive investing has grown in popularity in recent years, and this trend is likely to continue, given the relatively low cost for investors and the amount of index funds that are available on the market. However, the rise of passive investing raises concerns that index providers may have too much control over the market. Index providers often make key decisions about the makeup of indices, yet they are not regulated within the United States. Although index providers publish a great deal of methodology documents on their websites, they are not as easily accessible as the disclosures that funds must provide, nor are they presented in a uniform manner that is easier for investors to understand.

The lack of regulatory oversight for index providers can lead to a number of negative results: investors may lack transparency about the indices their funds invest in; the indices themselves may be subject to market manipulation; and index providers' decisions to reclassify economies as either frontier, developed, or emerging markets can affect public perception or investor access to a country's economy.

However, certain financial regulators are beginning to take a closer look at regulation of index providers. The IOSCO Principles and the BMR both evidence a desire by international financial regulators to subject index providers to some level of oversight, especially after the 2012 LIBOR manipulation scandal. In order to avoid future problems, and to maintain parity with the rest of the investment world, the SEC ought to adopt a regulatory framework for index providers. By requiring index providers to register with the SEC in a manner analogous to the current regulatory requirements for NRSROs, the SEC can monitor the behavior of index providers. Index providers will then publicly file changes and/or additions to internal rules for notice and comment. Publishing additions and changes to rules in a public forum will encourage public discussion and greater transparency. It seems likely that the passive investment trend will continue to rise in popularity. Providing a regulatory framework would be a welcome first step towards placing investors and index providers on a more level playing field.

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