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AFG response to the European Commission's consultation on the regulation of indices
A Possible Framework for the Regulation of the Production and Use of Indices serving as Benchmarks in Financial and other Contracts

General comments

The Association Française de la Gestion financière (AFG)[1] is grateful for the opportunity to answer to the European Commission's consultation on the regulation of indices, "a possible framework for the regulation of the production and use of indices serving as benchmarks in financial and other contracts".

AFG would like to stress that members are in majority users and not providers of indices.

[1] The Association Française de la Gestion financière (AFG) represents the France-based investment management industry, both for collective and discretionary individual portfolio managements. Our members include 425 management companies as of end January 2012. They are entrepreneurial or belong to French or foreign banking or insurance groups. AFG members manage 2,650 billion euros in the field of investment management as of end December 2011, making the Paris Fund Industry the leader in Europe for the financial management of collective investments. In the field of collective investment, our industry includes – beside UCITS – employee savings schemes and products such as regulated hedge funds/funds of hedge funds, private equity funds, real estate funds and socially responsible investment. AFG is of course an active member of the European Fund and Investment Management Association (EFAMA) and of Pensions Europe. AFG is also an active member of the International Investment Funds Association (IIFA).

AFG fully suports the authorities objective to remove the risk of manipulation of any indices, as its members are regular users of such datas for the management of assets or for the presentation to clients of portfolio performance.

AFG understands that the usage of indices for reporting and marketing purposes is not the point of the current consultation and that it is rightly not the intent of the European Commission to regulate the use of benchmarks in the fund industry.

AFG highlights that its members are asking for more transparency from indices providers. The expectation on transparency covers: construction of the index, underlying data, methodologies, contribution, composition and all information that can proof the adequacy of the bechmark to their need.

Indeed, as soon as june 2003 AFG participated within Eama (The European Asset Management Association that later merged with FEFSI to become Efama) to the publication of a “Code of Best Practice Recommendations For the Governance, Construction and Use of Equity Indices”

1. Indices and Benchmarks: what they are, who produces them and for which purposes

(2) Which benchmarks does your organization use? What do you use each of these benchmarks for? Has your organization adopted different benchmarks recently and if so why?

AFG members are commonly using all types of benchmarks as the French asset management industry encompasses all scope of products.

Indices used by asset managers include, among others, standard benchmarks such as Euribor, Libor or EONIA references on the short term; CMS or TME (French OATs) on longer maturities; I-TRAXX for credit; and standard equity indices such as CAC, Eurostoxx, Topix or SP 500 which are generally underlying for future contracts.

Some ETFs replicate the performance of more specialized indices (industry, country or maturity indices for example or composite indices...). Contracts on dividends or volatility require more attention as they are not always standardized.

(4) How many contracts are referenced to benchmarks in your sector?
Which persons or entities use these contracts? And for which purposes?

All types of benchmarks as defined in the chapter 1 are potentially used by asset managers in contracts they sign with their counterparty to management purpose.

(5) To what extent are these benchmarks used to price financial instruments? Please provide a list of benchmarks which are used for pricing financial instruments and if possible estimates of the notional value of financial instruments referenced to them.

Asset managers have to assess the value of their portfolios at market price and in that process they refer to market data and rarely use models (which incorporate also market data and not indices).

Structured derivative instruments referring to an index are valued at market price with a control which usually includes a reference to that index.

(6) How are benchmarks in your sector set? Are they based on real transactions, offered rates or quotes, tradable prices, panel submissions, samples? Please provide a description of the benchmark setting methodology.

Asset managers may use all types of indices based on: real transactions, offered rates or quotes, tradable prices or panel.

(7) What factors do you consider to be the most important in choosing a reliable benchmark? Could you provide examples of benchmarks which incorporate these factors?

We strongly believe that indices should offer a very high level of transparency which proves to be an efficient leverage on governance. Indeed it was one of the main points of the 2003 EAMA "Code of Best Practice Recommendations For The Governance, Construction and Use of Equity Indices".

Indices should comply, for example, with the following rules to be used as benchmarks:

- be produced by an institution showing high professional standards and proven experience,
- be established according to a detailed process,
- process should be published and available for investors,
- process should establish strict measures to operate changes in the index,
- publication of the index should make it available to the public at large,
- index should rely on data, published or contributed, stored and available for audit.

In case of composite indices all components should comply with these criteria and the internal procedure to rebalance and adjust should also be transparent.

As part of the transparency process asset managers could express and publish their policy on choosing benchmarks they use in their portfolios.

2. Calculation of Benchmarks: Governance and Transparency.

Professional managers monitor the indices used in the management of assets. But for that purpose, asset managers should be able to choose benchmark accurately and therefore need to have the correct information.

A code of best practices for providers of indices would bring transparency to the users. Asset managers could then be more accurate in the way they select indices and more consistent in term of transparency to the investors.

A regulatory framework is not necessary in our view as the scope of benchmarks would be too large to cover if we consider it is a global issue.

So to summarize and answer to questions of Chapter 2, as users of indices, we would suggest that providers communicate on more detailed information in order to develop transparency, like:

- Data: how they compensate when there is no data, publish the composition even with a delay, how they communicate the allocation of the components…
- Contributors: the list of contributors, how they do panels, how they control the potential conflicts of interest…
- Calculation methodology: which one and how may have changed in the past, which controls are made on the methodology etc…

This being paid, making contributing data or estimates to produce benchmarks a regulated activity would be a big constrain that would discourage contributors to participate to the indices construction.

To get a common framework, we suggest then that a code of best practice should be developed from providers of benchmarks. So users could make sure they get the full information and would be able then to select the appropriate benchmark to the appropriate target.

In that code, we would have two important specific suggestions concerning the benchmarks construction.

- The first one is on the calculation methodology. As regulation suggests that the benchmark reference to a performance should be with dividends reinvested, we would like those indices to be always provided when applicable by providers. Currently it is not always the case.
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- The second one is linked to component selection. As many countries, France has signed the Oslo and Ottawa Conventions against controversial weapons. Therefore AFG made a clear recommendation to its members that portfolios should not include shares or bonds of producers of cluster bombs and landmines. Publication at no extra cost of “clean” indices is therefore a necessity.

3. The Purpose and Use of Benchmarks

(30) Is it possible and desirable to restrict the use of benchmarks? If so, how, and what are the associated costs and benefits? Please provide estimates.

We don’t think it is possible and desirable to restrict the use of benchmarks in financial contracts. It is maybe necessary to make sure that they are in adequacy and maybe see if they need adjustments. This should be done on a case by case basis.

Regulators are legitimate to intervene if investor protection requires it or if systemic risks arise. As long as benchmarks are used by professionals and do not produce systemic risk, regulators should not restrict their use and the innovation it brings.

(31) Should specific benchmarks be used for particular activities? By whom? Please provide examples.

We don’t see any advantage of limiting the use of specific benchmarks for particular activities as long as the selection of the benchmark can be explained and that it corresponds to the objective of the management.

(32) Should benchmarks developed for wholesale purposes be used in retail contracts such as mortgages? How should non-financial benchmarks used in financial contracts be controlled?

We cannot comment on the credit side, including mortgages, but it is not appropriate in our view to limit access for the retail investment industry as they would not benefit then from the innovation most of the time first offered to the wholesale, all the more as retail documentation or commercialisation methods are already covered by a specific regulation strengthening investor protection Markets in Financial Instruments Directive (MiFID).

(33) Who should have the responsibility for ensuring that indices used as benchmarks are fit for purpose, the provider, the user (firms issuing contracts referenced to benchmarks), the trading venues or regulators?

In the case of indices serving as benchmarks in investment products, we don’t see the responsibility being ensured by only one participant. If a conflict surges, we suggest that this should be a case by case resolution as it is linked to the legal purpose of each contract.

4. Provision of Benchmarks by Private or Public Bodies

(34) Do you consider some or all indices to be public goods? Please state your reasons.

We consider that indices can be or not public goods. Some are specifically developed and are linked to a portfolio management process.

Considering ETF using benchmarks, as they ask for bespoke indices we can envisage addressing this on both sides: in one hand, the ETF manager should design an index picking policy, and, on the other hand, the producer of the index should comply with its own procedures in defining a new index and assessing its capacity to compute it on the long term.

(35) Which role do you think public institutions should play in governance and provision of benchmarks?

As said before it is difficult to regulate indices production. Public institution could of course provide indices. Two main roles should be nevertheless played.

First impose sanctions in case of frauds or breaches in Chinese walls.

Second make sure that index providers do not create monopoles enabling them to overcharge unduly their clients or make them systematically pay for any reference to an index, even when it is not used for portfolio management.

(36) What do you consider to be the advantages and disadvantages of the provision of indices by public bodies?

It could theoretically be expected that public bodies would have a high standard approach; would respect strict rules in establishing indices; would not suffer conflicts of interest acting as third parties and would provide indices free of charge or at low cost.

However experience showed that public statistics offices, even if they can remain immune to political pressure, have not always fit to that difficult task and it may be feared that they would be less reactive than commercial entities, thus limiting innovation in the industry.

5. Impact of Potential Regulation: Transition, Continuity and International Issues.

Production of indices is an international business and it is not appropriate to take a decision only at a national or a regional level. European regulation will not prevent third countries providers to establish indices that could suit European demand.

Change of index and transition to a substitute should be authorized, but not imposed by the regulator. It may be appropriate to include a clause in the documentation whereby counterparties agree to either close the contract or change reference if necessary or simply suitable to both.

If you need any further information, please don't hesitate to contact myself, at +33.1.44.94.94.29 (p.bollon@afg.asso.fr) or Eric Pagniez at +33.1.44.94.94.06 (e.pagniez@afg.asso.fr).

Sincerely Yours,

(signed)

Pierre BOLLON