SEC Request for Comment on "Information Providers"

On June 15, 2022, the Securities and Exchange Commission (the "SEC") issued a request for comment to "help determine which 'information providers,' such as index providers, model portfolio providers, and pricing services, might come under the SEC's definition of an investment adviser."[1] The request for comment (the "RFC") discusses the roles played by these entities in, for example, the construction and calculation of indices, and analyzes the factors used to determine whether an entity is providing investment advice within the meaning of the Investment Advisers Act of 1940 (the "Advisers Act"). Among other things, the SEC is concerned about what it terms "significant discretion" in index methodologies.[2]

The RFC is an Advisers Act and Investment Company Act of 1940 (the "1940 Act") release, and is mainly concerned with Advisers Act issues. However, the potential effect of any rulemaking in response to this RFC will reach beyond Advisers Act issues and, in the context of index providers, affect other securities linked to indices, such as structured notes, as well as derivatives that reference indices. Consequently, this article discusses these potential effects on the broader market and not just in the context of, for example, registered funds or variable annuities.

Who are the Information Providers?

The RFC focuses on three industry players, which together comprise the information providers:

- "Index providers," which "compile, create the methodology for, sponsor, administer and/or license market indices."[3] This group is broad enough to run the gamut from large, well known index providers like S&P Dow Jones Indices LLC, Bloomberg, and FTSE Russell, and also include an arm of an investment bank creating custom, proprietary indices. The term index is not defined, either in the RFC or elsewhere in the federal securities laws. Given the discussion elsewhere in the RFC, it is likely that the SEC may mean "index" in a broader sense than it is sometimes used in practice – potentially including, for example, embedded strategies or stock baskets.
- "Model portfolio providers," which design custom portfolios of assets (mutual funds and exchange-traded funds ("ETFs") are used in the RFC as an example) "designed to achieve a particular return, with corresponding risks." These model portfolios may be rebalanced or have constituent changes over time, and offer various degrees of customization.[4]
- "Pricing services," which provide "prices, valuations, and additional data about a particular investment (*e.g.*, a security, derivative, or another investment), to assist users with determining an appropriate value

> of the instrument." Pricing services may provide prices when they are not available through a normal, arm's-length third-party transaction, such as when relevant markets are closed.

What is the SEC's Concern?

The SEC is concerned that the activities of the various information providers may cause them to fall within the definition of an "investment adviser" under Section 202(a)(11) of the Advisers Act. Information providers whose activities are determined to cause them to fall within that definition would, absent an exemption, be required to register as an investment adviser with the SEC.

As summarized in the RFC:

> The Advisers Act generally defines an "investment adviser" as any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or any person who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities. The definition generally includes three elements for determining whether a person is an investment adviser: (i) the person provides advice, or issues analyses or reports, concerning securities; (ii) the person is in the business of providing such services; and (iii) the person provides such services for compensation. Each element must be met in order for a person to be deemed an investment adviser.[5]

The SEC analyzed the three elements of the definition, noting that (i) a person generally is an investment adviser even if its advice, reports, or analyses about securities do not relate to specific securities, provided the services are performed as part of a business and for compensation, (ii) giving advice does not need to constitute the principal business activity or any particular portion of the business activities of a person in order for the person to be considered "in the business" of acting as an investment adviser; the giving of advice need only be done on a basis such that it constitutes a business activity occurring with some regularity and (iii) the source of an "economic benefit" that would satisfy this element of the definition is not limited to fees and commissions.[6] The SEC also noted that the Staff has considered whether data, in the context of "databases and various computer software services offering calculation and pricing models," might constitute "analyses or reports concerning securities" within the meaning of Section 202(a)(11) of the Advisers Act.[7]

Last, the SEC discussed and questioned the applicability of the "publisher's exclusion" in Section 202(a)(11)(D) of the Advisers Act, which excludes from the definition of "investment adviser" any "publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation." As discussed in the RFC, the Supreme Court has held that "publishers are excluded from the definition under the Advisers Act as long as their publication: (i) provides only impersonal advice; (ii) is 'bona fide,' meaning that it provides genuine and disinterested commentary; and (iii) is of general and regular circulation rather than issued from time to time in response to episodic market activity."[8]

The SEC stated its interpretation of how the publisher's exclusion is used, and its concerns:

> Certain providers have relied on the publisher's exclusion. We believe that index providers have historically concluded, for example, that, even if they meet the definition of investment adviser, they may rely on the exclusion and thus need not register with the Commission or be subject to any section of the Advisers Act, including section 206. Similarly, other providers, such as pricing services, may be relying on the publisher's exclusion. Given the length of time since *Lowe* was decided, and understanding that new business models have developed in the interim, we are considering the extent to which providers' activities, in whole or in part, may raise investment adviser status issues.[9]

The SEC's Assumptions About Information Providers

There are a number of statements and assumptions in the RFC that do not reflect actual industry practice.

For example, this is the RFC's summary of how an index provider operates:

> Index providers compile, create the methodology for, sponsor, administer, and/or license market indexes. They typically determine the particular "market" (which may be a sector or other group of securities) that the index measures, the index constituents that measure that market, and the weightings that each constituent receives. Once the index is designed and its methodology is created, index providers determine the index's level (or measurement) pursuant to that methodology. *These activities leave room for significant discretion—for example, an index provider typically has the ability to make changes to the index by adding or dropping particular constituents (i.e., index reconstitution) or modifying their weighting within the index (i.e., index rebalancing), in some cases without publicly disclosing their index methodologies or rules*.[10]

The footnote citation for the last sentence above is to a law review article, which states that "'[C]ompiling an index … is an inherently discretionary exercise.'"[11]

Why and How Index Providers Avoid Discretion

The SEC is concerned about the abuse of unregulated advice and discretion. Advice and discretion are assiduously avoided by index providers.

Index providers avoid discretion by using precise, replicable, rules-based methodologies. Index providers design their indices and methodologies so that if an index is transferred from one sponsor to another, the new sponsor will be able to continue to operate the index without interruption. Vague methodologies, or those with significant discretionary elements, will not transition smoothly to a successor index sponsor.

Ministerial discretion in an index methodology is acceptable. For example, the index methodology of an equities or commodities index will set forth certain market disruption events, which may cause the index sponsor not to publish the index level for the disrupted day, or provisions for substitutions or replacements of components under certain circumstances. Often there will be limited discretion involved under these circumstances. Valuing a distribution of property to equity index component owners in a merger, spin-off or other distribution event may require an exercise of judgment by the index calculation agent. Substituting an index component for another after a merger or bankruptcy of the original component may require some discretion. However, none of this constitutes an "inherently discretionary exercise."

EXISTING GUIDELINES FOR INDEX PROVIDERS

Although there are no U.S. regulations governing indices, the NYSE Arca, Nasdaq and Cboe BZX exchanges have similar generic listing rules for securities, such as structured notes, exchange-traded notes or ETFs linked to an underlying index. The generic listing rules, which are reviewed and approved by the SEC, are designed to ensure that an index is "broad" and not "narrow." A narrow-based index may raise questions about whether the index is a bona fide index, or whether the so-called index is actually designed for some other purpose. For example, a model portfolio would not satisfy the generic listing rules of the exchanges. Index providers and their counsel assess any new index against the generic listing rules since the generic listing rules have been approved by the SEC.[12] As part of an exchange's review of an application for a listed security linked to an index, such as an exchange-traded note, the exchange will review the index methodology. Any discretion in an index methodology will be questioned by the exchange and be cause for rejection.

THE USE OF DISCRETION IN AN INDEX MAY CAUSE ADVERSE TAX CONSEQUENCES

Another reason well-advised index providers generally avoid index discretion is that the Internal Revenue Service may scrutinize it. In 2015, the Internal Revenue Service published a notice labelling as "transactions of interest" transactions where a taxpayer enters into a financial instrument over a basket of reference assets and taxpayer or its designee has discretion to change the reference assets in the basket during the term of the instrument. If participating in a "transaction of interest," a taxpayer and certain advisors with respect to the transaction are required to report the transaction to the Internal Revenue Service or face penalties for a failure to do so. The Internal Revenue Service drafted the notice broadly enough that it could arguably be read to pick up a financial instrument linked to the performance of an index if the index sponsor has discretion (and an exception in the notice does not apply).[13] Since the release of this notice, well-advised index providers and other market participants have carefully reviewed discretion within index methodologies (if any) in light of what the notice views as acceptable.

THE INFLUENCE OF THE IOSCO PRINCIPLES AND THE EU BENCHMARK REGULATIONS

Although U.S. index providers are not bound to follow the International Organization of Securities Commissions ("IOSCO") Principles, the major index providers have publicly stated that they conform to the IOSCO Principles when creating indices (without qualification as to whether a broad-based or customized index).[14] The IOSCO Principles are a set of best practices, which include guidelines that restrict the exercise of "expert judgment" by the index sponsor, and also set forth procedures and practices designed to promote consistency in the exercise of expert judgement between benchmark determinations. The IOSCO Principles also address data sufficiency and data hierarchy.[15]

Index providers look at the data inputs used by the index and consider the data's sufficiency. Indices based on prices, rates, indices or values formed by competitive forces of supply and demand (i.e., an active market) with observable, bona fide, arm's-length transactions provide confidence that the price discovery system is reliable. For example, prices of equity securities or exchange-traded funds trading on national securities exchanges provide the highest level of comfort. Similarly, prices of publicly traded futures contracts on commodities would also provide the highest level of comfort.

Not every index is constructed solely from transactional data. If an active market exists, the index sponsor may rely on data tied to observable market data as an adjunct or supplement to transactional information. If allowed by the methodology, an individual index determination could be based predominantly or exclusively on bids and offers or extrapolations from previous transactions. Where an active market exists, an index sponsor is not precluded from using executable bids or offers as means to construct an index if those bids or offers are anchored in an observable market consisting of bona fide, arms-length transactions. This approach could be appropriate in a market in which there may be more firm bids and offers than posted transactions taking place from time to time if overall transaction volume in that market is high over sustained periods.

According to the IOSCO Principles, where prices or values of an underlying component are not available on, for example, a national securities exchange or other public market, in general, the hierarchy of data inputs for an index component should follow these guidelines, in descending order:

- The data submitter's own concluded arms-length transactions in the underlying index component or related markets if an index is dependent on submissions;
- Reported or observed concluded arms-length transactions in the underlying index component;
- Reported or observed concluded arms-length transactions in related markets;
- Firm (executable) bids and offers; and

- Other market information or expert judgments.[16]

The guidelines above are flexible, provided that an active market exists. For example, an index methodology may allow reliance on expert judgment in an active market with low liquidity when transactions may not be consistently available each day. The IOSCO Principles state that their application is proportional to the size and risks posed by the index in question.

Sales of index linked securities to retail investors in the European Union ("EU") may implicate the EU Benchmark Regulations. These EU regulations regulate index sponsors, or "benchmark administrators." Consequently, U.S. issuers of index linked securities who are in compliance with relevant EU Benchmark Regulations, and U.S. index providers, could find themselves with a conflict of laws issue if the SEC were to issue new regulations.

Other SEC Concerns About Information Providers

In the RFC, the SEC stated that:

> [t]hese providers' operations also raise potential concerns about investor protection and market risk, including, for example, the potential for front-running of trades where the providers and their personnel have advance knowledge of changes to the information they generate and potential conflicts of interest where the providers or their personnel hold investments they value or that are constituents of their indexes or models.[17]

These concerns are at odds with index providers' practices. Index providers affiliated with a broker-dealer or issuer of securities maintain information walls to prevent the desk or other business personnel from having any influence over, or access to, the operation of the index, particularly rebalancings. The information wall works the other way, too, in that if the broker-dealer affiliate has access to material non-public information about an index constituent (such as the issuer of an equity security), that information will have no bearing on the operation of the index. These walls prevent the sort of self-dealing that seems to be a concern of the SEC.

The NYSE Arca also addresses these issues in Equity Rule 5.2-E(j)(6)(C) in the context of structured notes: "If the value of an Index-Linked Security listed under Rule 5.2-E(j)(6) is based in whole or in part on an index that is maintained by a broker-dealer, the broker-dealer shall erect and maintain a 'firewall' around the personnel responsible for the maintenance of such index or who have access to information concerning changes and adjustments to the index, and the index shall be calculated by a third party who is not a broker-dealer."

NYSE Arca Equity Rule 5.2-E(j)(6)(C) goes on to require "[a]ny advisory committee, supervisory board or similar entity that advises an index licensor or administrator or that makes decisions regarding the index or portfolio composition, methodology and related matters must implement and maintain, or be subject to, procedures designed to prevent the use and dissemination of material, non-public information regarding the applicable index or portfolio."

In addition to the existing rules and market practices described above, it is not clear that there would even be incentives for information providers to act as the SEC fears. Information providers are providing are not invested in the performance of the performance of the indices or models that they create and would not directly benefit from the performance of these measures.

The SEC also noted that some information providers cannot register as investment advisers with the SEC because they lack sufficient regulatory assets under management – *i.e.,* they are, in the view of Congress (and historically the SEC), too small to matter. However, through supposition, the SEC is concerned that nonetheless these information providers may affect national markets: "Depending on the facts and circumstances, however, particular information providers *may* have an ability, *perhaps* through operations of sufficient size and scope, to affect national markets or otherwise have a 'national presence.'"[18]

Pricing Services

The SEC is concerned that "[i]n providing pricing information to users, pricing services may exercise significant discretion."[19] As discussed above, most index providers obtain their own data. Whenever an index provider uses a third-party service, like a pricing service, it cannot turn a blind eye to the operation of the third-party service.

Under the IOSCO Principles, all outsourcing of any activities relating to index administration to third parties, such as collection of pricing data, should be subject to appropriate oversight by the index provider:

- Review the written agreements between the index provider and any third parties. Agreements should clearly define and substantiate the third parties' roles and obligations, as well as the performance standards set by the index provider. Contingency plans should be in place to avoid operational risk in the event of disruptions on the part of any third party.
- Ensure that third parties' compliance with standards set out by the index provider is being monitored.
- The identities and roles of any third parties should be available to investors.[20]

The generic exchange listing rules provide some guidance on pricing. When listing a commodity linked security, the NYSE Arca requires that:

> The pricing information for components of a Commodity Reference Asset must be derived from a market which is an [Intermarket Surveillance Group] member or affiliate or with which the Exchange has a comprehensive surveillance sharing agreement. Notwithstanding the previous sentence, pricing information for gold and silver may be derived from the London Bullion Market Association.
> A Commodity Reference Asset may include components representing not more than 10% of the dollar weight of such Commodity Reference Asset for which the pricing information is derived from markets that do not meet the requirements of this subparagraph (b); provided, however, that no single component subject to this exception exceeds 7% of the dollar weight of the Commodity Reference Asset.[21]

Index providers creating an index measuring commodities would generally follow this requirement, even for unlisted securities linked to the index. As under the IOSCO Principles, there is room for pricing information that does not come from a recognized exchange.

Requests for Comments

The requests are wide-ranging, including:

Are the SEC's descriptions of the information providers accurate?

- Asking about the components of investment adviser status in the context of the activities of information providers
- Do information providers rely on the publisher's exclusion, and *Lowe v. SEC*?
- Does an index that is specialized raise investment adviser issues?
- Do index providers limit the dissemination of their methodologies or indexes to only those who license such information?

The RFC raises other regulatory implications for Index Providers and Pricing Services including:

- To the extent "continuous and regular supervisory or management services" are not provided, on what basis could an index provider or pricing service register with the SEC versus multiple states?
- If a registered investment company uses products and services of an index provider or pricing service (as many do in some manner, e.g., custom indices or pricing of fund holdings), would that require the registered investment company to subject the contract for such services to the requirements of Section 15 of the 1940 Act (such as requiring a majority of shareholders to approve of the contract)?
- If deemed to be an investment adviser of a registered investment company, the index provider or pricing service would become a first-tier affiliate of the registered investment company. What implications of being a first-tier affiliate to that fund apply to the index provider or pricing service if the index provider or pricing service is part of a financial institution, including a broker-dealer, that engages in other activities with the registered investment company (such as acting as an executing broker or dealer, or extending a loan to the registered investment company)?
- Who is the client when an index provider or pricing service is hired by an investment adviser? The answer to this question will have far-reaching implications regarding disclosure obligations, scope and expanse of fiduciary duty, and suitability determinations, not all of which are solved with disclosure.
- In performing due diligence of an index provider or pricing services, will an investment adviser or a registered investment company need to fully evaluate the policies and procedures of the index provider or pricing service to fulfill requirements arising under 1940 Act Rule 38a-1 and Advisers Act Rule 206(4)-7?

The RFC raises these and many other implications of the outcome of imposing investment adviser status on index providers and pricing services. To the extent the RFC results in a requirement that many will need to become registered under the Advisers Act, the open issues described above could not be called "unintended consequences."

Conclusion

We cannot say that we weren't warned. In her address to the ICI 2018 Mutual Funds and Investment Management Conference, Dalia Blass, former director of the Division of Investment Management, stated her concerns about the use of the publisher's exclusion:

> Under the Advisers Act, I believe index providers have historically concluded that, even if they are investment advisers, they may rely on the publisher's exclusion from the definition of "investment adviser." However, recent developments appear to have moved certain index providers away from what we might think of as publishers.
>
> I do not mean to suggest that we should revisit this analysis with respect to broad-based indexes that are widely used. But what should we make of an index that the provider maintains for only one single fund? What if the provider takes significant input from the fund's sponsor or board regarding the creation, composition or rebalancing of that index? Should affiliation between the index provider and the sponsor affect the conclusion?
>
> Clearly this is a facts and circumstances analysis without a bright-line.[22]

Compare this measured approach to the broad approach taken by the RFC. Ms. Blass separates out broad based indices as raising no concerns. In the RFC, it is stated that index methodologies are "inherently discretionary," citing only a law review article as support.[23] Also on a lesser scale, and with a different emphasis, were former Chair Jay Clayton's comments in his speech to the Fixed Income Market Structure Advisory Committee on November 4, 2019:

> Do investors and those who advise investors understand how indices are constructed from (1) a technical perspective (e.g., weightings, adjustments and the like), (2) from a market exposure perspective (e.g., opportunities and risks the index incorporates), and (3) as a subset of those opportunities and risks, any key value judgments the index provider has made (e.g., to include or exclude certain types of companies)? I have some concerns in this regard as I have had many discussions with investors where they express concern about particular risks and choices yet it appears these concerns are not reflected to the same extent when they index invest. As one question, should we encourage or require more disclosure?[24]

With a different SEC, we now have a RFC foreshadowing potential rulemaking where the activity is largely addressed by existing regulatory frameworks.

Comments are due 30 days after publication in the Federal Register or August 16, 2022, whichever is later.

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Endnotes

[1] *See* SEC Chair Gary Gensler's statement available at: https://www.sec.gov/news/statement/gensler-statement-comment-certain-information-providers. The request for comment (Rel. Nos. IA-6050; IC-34618 (June 15, 2022)) is available at: https://www.sec.gov/rules/other/2022/ia-6050.pdf.

[2] *See* the RFC at note 4 and surrounding language.

[3] *See* the RFC at pp. 4-6.

[4] *See* the RFC at pp. 7-9. This article does not discuss model portfolios because this market appears to be limited to institutional accounts or sophisticated investors, not retail clients.

[5] RFC at 11 (footnote omitted).

[6] *See* the RFC at pp. 11-13.

[7] *See* the RFC at 13.

[8] RFC at 14 (citing *Lowe v. SEC*, 472 U.S. 181, 208-210 (1985)).

[9] RFC at 15.

[10] RFC at pp. 4-5 (footnote omitted) (emphasis added).

[11] *See* RFC at note 4.

[12] *See, e.g.,* NYSE Arca Equity Rule 5.2-E(j)(6). The Nasdaq and Cboe BZX Exchange have substantially similar generic listing rules. *See* Nasdaq Rule 5710 and Cboe BZX Exchange Rule 14.11(d).

[13] For a more detailed discussion of the notice, see Thomas. A. Humphreys, Remmelt A Reigersman, and Brennan W. Young, New Notices for "Basket Contracts" Revoke and Replace July Notices, Journal of Taxation of Financial Products (January 26, 2016). If you have trouble locating the article, a pdf is available upon request.

[14] *See e.g.,* "S&P Dow Jones Indices Completes Its Annual Review of Adherence with IOSCO Principles for Financial Benchmarks" at: https://press.spglobal.com/2021-09-16-S-P-Dow-Jones-Indices-Completes-Its-Annual-Review-of-Adherence-with-IOSCO-Principles-for-Financial-Benchmarks; *See* FTSE Russell Statement of Compliance at https://research.ftserussell.com/products/getdocument?product=IOSCO.

[15] The IOSCO Principles are available at: Principles for Financial Benchmarks (iosco.org).

[16] *See* IOSCO Principle 8.

[17] RFC at pp. 3-4

[18] RFC at 4 (emphasis added).

[19] RFC at 10.

[20] *See* IOSCO Principle 2.

[21] NYSE Arca Rule 5.2-E(j)(6)(B)(II)(1)(b).

[22] The Blass speech is available at: https://www.sec.gov/news/speech/speech-blass-2018-03-19.

[23] *See* the RFC at pp. 4-5 and n.4.

[24] The Clayton speech is available at: https://www.sec.gov/news/public-statement/statement-clayton-fimsac-110419.