Article 30 and Independent Index Providers

This paper looks at the impact of the Article 30, which grants non-discriminatory access to licence benchmarks, on so called independent index providers. It sets out the background to article 30, the development of benchmarks, the concerns of the independent index providers and finally outlines policy options to address these concerns. The recommendation is to maintain the current position.

A. Benchmarks

What are Benchmarks?
Benchmarks are defined in Article 2(24) of the MIFIR proposal as:

> *"any commercial index or published figure calculated by the application of a formula to the value of one or more underlying assets or prices by reference to which the amount payable under a financial instrument is determined."*

Benchmarks these are used for a variety of reasons, in particular:-

1. **Creating financial instruments –** such as futures, options and other derivatives and investment portfolio products such as Exchange Traded Funds.
2. **Hedging –** and risk management – although this may be achieved by purchasing the products outlined above.
3. **Price measurement –** in some markets, in particular physical commodity markets and to a lesser extent bonds, the benchmark may be the main price identifier in a market.
4. **Other** - Performance measurement and general research

Development of benchmarks
Commodity indexes have existed for a long time. For example the Economist's Commodity-Price Index has been published for nearly 150 years (since 1864). However, this index, like many of the earlier indexes, tracks prices (i.e. function 3 above) and was not investable product (i.e. function 1). The past 20 years have however seen a growth in investible indexes. In both the commodities, equities and derivatives spheres indices have evolved from simple baskets of representative prices to products which incorporate or adjust for other important factors in investment or risk management decisions, such as the liquidity of the underlying securities.

However in some sectors the market may have reached a plateau of technical development "*Equity benchmark indices have evolved over the last decade in such a way that there is now a broad level of similarity in their methodology, treatment of corporate actions, definitions of benchmarks and general index processes. Thus, when investors examine indices from* *providers such as Dow Jones, FTSE, MSCI, S&P and STOXX, there will tend to be top-level convergence in index design and methodology.*[1]"

Instead a large part of competition – or barriers to competition - is conducted through ownership of property rights to indices and benchmarks. For example STOXX, (owned by Deutsche Börse and Six Swiss Exchange) has refused Turquoise Derivatives (owned by LSE) offering derivatives products based on the Euro STOXX set of indices. More broadly the ownership and restrictive licensing of these indices has potentially prejudiced wider market stability concerns, as for example during the recent Euronext outage.

In light of the above it is worth considering that intellectual property rights have two effects:

a) On the one hand the rights to the rents to innovated products stimulates the development of new products – which benefits society.

b) On the other hand, the conferral of monopoly rights on the innovator restricts competition, raises the price of the innovated product and so restricts its adoption. These effects constitute a cost to society.

Within any class of product, there may be decreasing marginal benefits to further developments of that product meaning that over time the benefits in a) decrease while the costs in b) increase (since the product is now more widely used). It may be that benchmarks have reached this point- all of the large gains have already been achieved and most of the current innovation is of marginal benefit.

B. Independent Index Providers Concerns about Article 30

Article 30 of MIFIR Proposal

Article 30 of MIFIR is part of the non-discriminatory clearing access for financial instruments provisions and requires the owner of the intellectual property in any benchmark to provide access on a transparent and non-discriminatory basis to central counterparties that wish to clear transactions executed on the trading venue to a) relevant price and data feeds and information on the composition, methodology and pricing of that benchmark and (b) licences. The intention is to remove barriers and reduce discriminatory practices, in particular to break down vertical silos, and thereby increase competition in the sector.

The MIFIR impact assessment, and the policy development process, focused on trading venues and CCP as the holders of the intellectual property subject of the compulsory licensing requirements. However there are also providers which are independent of the venues and CCP's which develop and own intellectual property in benchmarks and which were not considered explicitly in the impact assessment.

Objections of independent index providers

[1] Ishares http://uk.ishares.com/en/pc/literature/document-success?url=%2Fstream%2Fpdf%2Ffalse%2F%3Furl%3D%2Fpublish%2Frepository%2Fdocuments%2Fen%2Fdownloads%2Fbrochure_equity_index_guide.pdf

An independent index providers association was formed which has argued that the provisions of Article 30 are not justified, in particular in relation to independent providers because:-

- There is no market failure in the Benchmark sector which is and remains competitive;
- Market forces ensure adequate transparency of methodologies[2];
- There has been no failure in the anti-trust regime in relation to benchmarks which requires separate legislation;
- Is incompatible with existing rights for the ownership of intellectual property – in particular the Madrid Protocol, the WIPO and the Convention For The Protection Of Human Rights And Fundamental Freedoms.

And could have detrimental effects because it would:-

- Reduce investments and innovation in benchmarks – in particular by encouraging free riding;
- Reduce the market diversity and open the potential for licensed data to be misused;
- Disadvantage European providers in this global market and potentially raise concerns vis a vis extra territoriality.

High Level Assessment of Index Providers Concerns

In some respects the independent provider's opposition to the proposal in Article 30 is surprising; as currently structured, the market does not favour the independent providers but rather the venues that have monopolistic control over the unique benchmarks as both the developers of the benchmarks and "controllers" of the market for these benchmarks.

Article 30 will in effect create fungible benchmarks in a competitive market; the best producers of benchmarks are likely to benefit and benchmark producers that are not tied to any one venue should be best placed to offer benchmarks to all the venues. In both cases independent benchmark providers seem to be the best candidates to exploit these opportunities.

This would of course not be without some internal dislocations. At present the independent benchmark providers tend to work closely in developing benchmarks with single venues; successful benchmarks may then be licensed more widely. Article 30 is likely to break open these cosy bilateral relationships and some providers may be better at exploiting marketing benchmarks to the market as a whole rather than on a bilateral basis. As with any competition enhancing measure there will be winners and losers.

Assessment of Specific Index Providers Concerns

a. The market is already competitive: the independent index provider providers' argument that the markets are competitive is made on the basis that the benchmarks are substitutable because the correlations between the various indices are close to 1 (see Annex 3). However

[2] For example MSCI provides its indices to clients for a fee, also discloses the index levels and historical performance) for a number of its indices on its website (www.msci.com) and posts its index methodologies on www.msci.com. MSCI also permits (and licenses the rights to) clients to reproduce and distribute (i) certain index level performance data as well as limited constituent level data as legally required, and in prospectuses, Key Investor Information Documents (KIID), fact sheets, reports, research and other informational materials, as well as in portfolio composition files for ETFs for creation/redemption, and (ii) certain data to regulators as required. Sometimes redistribution of MSCI data is on a delayed basis

for many participants close to 1 is not enough, those hedging index futures want to avoid all basis risk. The Commission has been told[3] that even a white label clone of an index would not be successful in attracting demand because of the risk that certain parameters would be calculated differently from the benchmark.

This is because the calculation is not always a purely objective mathematical mechanism – in certain areas index providers need to exercise discretion. A key element in a customer choosing a particular benchmark may therefore be trust and confidence in the way in which the benchmark provider will exercise this discretion. This means

- Firstly that the quantitative elements that will be disclosed under Article 30 are probably not critical to business models and so concerns about disclosure are over blown.

- Secondly , where discretion is exercised, it is likely to be exercised with one eye to the customer base. In the current market this is limited to the venues' clients. In an open post Article 30 world, it is more likely that discretion would be exercised with an eye on the market as a whole, since the market as a whole is the potential client base. This is likely to result in a fairer and more efficient exercise of discretion. These points argue for the maintenance of Article 30.

b. Transparency: significant transparency is already provided by the market. However, as discussed above, this may be because the quantitative methodologies are no longer the critical elements of the product. The independent index providers' arguments that market forces ensure transparency may rather reinforce the arguments above regarding the competitive evolution of this market.

c. Global Market: the market for indices is global. However as evidenced by the recent announcement of the cross listing of leading emerging market indices the trend may be towards cross listing and licensing rather than tight proprietary control and to this extent Article 30 may be moving the European market in the right direction[4].

d. Independence: it is not clear how "independent" all the independent index providers are:

- McGraw Hill is owned by the CME Group so not entirely independent;
- STOXX is owned by Deutsche Börse AG;
- MSCI was controlled by Morgan Stanley.

Even for the other providers such as MSCI, benchmarks are initially developed for and in close cooperation with a specific venue and then marketed and sold exclusively through that venue. They are generally only licensed more widely if the benchmark proves successful. To

[3] In particular by the LSE

[4] Recent announcement that the five of the world's leading emerging market indices would commence cross list their derivative indices on each other's trading platforms from March 30 2012. The cross-listing of benchmark equity index derivatives is likely to facilitate liquidity growth in the BRICS markets and will considerably strengthen their international position. The derivatives to be cross-listed will include Brazil's IBOVESPA futures, Russia's MICEX Index futures, India's Sensex Index futures, Hong Kong's Hang Seng Index futures and Hang Seng China Enterprises Index futures, and South Africa's FTSE/JSE Top40 futures.

the extent that independent providers businesses are dependent on exclusive bilateral relations with the venues, it is not clear how independent they are.

C. Policy Options

In light of the analysis above there are three policy options:-

Option 1 – Delete Article 30
If the independent index provider's arguments are accepted then there may be a case for deleting Article 30 and maintaining that Article 28 on access is sufficient to enhance access in this area. 4 amendments in the European Parliament have proposed deleting the entire article.

However for the reasons given above, our view is that the IIP case is not made and that article 30 is required to ensure open access, break down vertical silos and enhance competition.

Options 2 Amend Article 30 to Carve Out IIPs or otherwise weaken it
A potential compromise would be to amend "*a person with proprietary rights to the benchmark*" to read "*CCP, trading venue or any related person"* in the first line of Article 30 or something similar. A similar provision to exclude investment firms has also been tabled in the European parliament.

This would therefore exclude the application of Article 30.1 to independent providers that are not related to CCP's and Trading venues which is consistent with the original intention of the impact assessment. This would have the advantage of enhancing competition in the areas that we originally intended while preserving the benefits of competition that the independent index providers introduce.

However the potential disadvantages of this approach are:-

> a) defining "*related*" would require Level 2 guidance under Article 30.3 but the difficulty is that related could occur without ownership. For example IIP A may be entirely separate from venue B in terms of ownership structure. But IIIP A may be the sole provider of benchmarks to venue B and venue B may be its same revenue source. The venues may therefore simply outsource all their intellectual property rights to captive IIP's and therefore circumvent the regulations. This could obviously be mitigated through L2 measures to ensure that independent index providers are genuinely independent – i.e. looking at the provision of services etc. But it would be in effect a form of managed competition which would be substantially less than the clean solution that we have drafted.
>
> b) Carving out IIP's may undermine the force of our argument to open up the sector to competition. In the wider context of Mifid we have frequently argued for the principle of same business same rules; it would then be difficult to argue in this area that this sector of the business should be subject to such radically different rules.

Option 2B: a couple of other parliamentary amendments expand on the proposal to variously grant exclusive licenses for a limited period or in limited circumstances with compulsory licensing thereafter or on application to the commission. These amendments suffer from the above problems but are probably even less attractive since the elements involving commission decision making would be time consuming and require active micro management of the sector.

The possibility of time limited exclusivity probably has more merit but again weakens the force of the argument.

Option 3 Leave Article 30 as drafted

The preferred option would therefore be to leave Article 30 as drafted. Any particular detailed issues can be dealt with by the empowerment to make a delegated act

Other Policy issues – Price - a number of parliamentary amendments either propose deleting or amending Article 30(1) where it provides that access is at "*the lowest price at which access to the benchmark is granted*". There is some merit in these arguments since the current drafting potentially may have the perverse effect of encouraging licencing at a higher price than would otherwise be set. There are a number of alternative suggestions – principally along the lines that charges should be on a commercially reasonable basis. The disadvantage here is that the potentially wide interpretation of such provisions may weaken the effect of the overall package.

Annex A

Article 30
Non-discriminatory access to and obligation to licence benchmarks

1. Where the value of any financial instrument is calculated by reference to a benchmark, a person with proprietary rights to the benchmark shall ensure that CCPs and trading venues are permitted, for the purposes of trading and clearing, non-discriminatory access to:

> *(a) relevant price and data feeds and information on the composition, methodology and pricing of that benchmark; and to*
> *(b) licences.*

Access to that information shall be granted on a reasonable commercial basis within three months following the request by a CCP or a trading venue, and in any event at a price no higher than the lowest price at which access to the benchmark is granted or the intellectual property rights are licensed to another CCP, trading venue or any related person for clearing and trading purposes.

2. No CCP, trading venue or related entity may enter into an agreement with any provider of a benchmark the effect of which would be either:

> *(a) to prevent any other CCP or trading venue from obtaining access to such information or rights as referred to in paragraph 1; or*
> *(b) to prevent any other CCP or trading venue from obtaining access to such information or rights on terms any less advantageous than those conferred on that CCP or trading venue.*

3. The Commission shall adopt by means of delegated acts in accordance with Article 41, measures specifying:

> *(a) the information to be made available under paragraph 1(a);*
> *(b) the conditions under which access is granted, including confidentiality of information provided.*

ANNEX 2
Extract from Impact Assessment on article 30

19. ANNEX 9: SUMMARY OF SECONDARY POLICY OPTIONS CONSIDERED

19.1. Under the operational objective "Regulate appropriately all market structures and trading place taking into account the needs of smaller participants"

(b) Non-discriminatory clearing access for financial instruments

In addition to requirements in Directive 2004/39/EC that prevent Member States from unduly restricting access to post trade infrastructure such as central counterparty and settlement arrangements, legislation should remove various other commercial barriers that can be used to prevent competition in the clearing of financial instruments. Barriers may arise from central counterparties not providing clearing services to certain trading venues, trading venues not providing data streams to potential new clearers or information about benchmarks or indices not being provided to clearers. Without access to the central counterparty, positions involving similar financial instruments could not be netted down by participants. This would prevent competition from new trading platforms as it would be economically unviable for participants to use them.

The policy option is to prohibit discriminatory practices and remove barriers that may prevent competition for the clearing of financial instruments. Central counterparties should accept to clear transactions executed in different trading venues, to the extent that those venues comply with the operational and technical requirements established by the central counterparty.

Access should only be denied if certain access criteria specified in delegated acts are not met. This will increase competition for clearing of financial instruments in order to lower investment and borrowing costs, eliminate inefficiencies and foster innovation in European markets.

The policy option will also require trading venues to provide access including data feeds on a transparent and non-discriminatory basis to central counterparties that wish to clear transactions executed on the trading venue. Licensing and access to information about indices and other benchmarks that are used to determine the value of financial instruments should also be provided to central counterparties on a non-discriminatory basis. The removal of barriers and discriminatory practices is intended to increase competition for clearing of financial instruments in order to lower investment and borrowing costs, eliminate inefficiencies and foster innovation in European markets.

ANNEX 3
Correlations between indices

[4.2]

But it is probably the deviations that matter…

[4.2]

And correlations between indices have been converging

[4.2]

although this may be part of a recent secular convergence of correlations amongst all instruments..

ANNEX 4
Market Summary

The Mcgraw-Hill Companies, Inc.
The McGraw-Hill Companies is a leading global financial information and education group with interests in both the provision of energy and commodities price assessment and information services for the oil, natural gas, electricity, emissions, nuclear power, coal, petrochemical, shipping, and metals markets, and in the provision of globally-recognised benchmark portfolio indices. The group is headquartered in New York and has more than 280 offices in 40 countries.

Platts
Platts is a division of The McGraw-Hill Companies (NYSE-MHP), since 1953. Established in 1909, Platts is a leading global provider of energy, petrochemicals and metals information, and a premier source of benchmark price assessments for those commodity markets. Platts publishes news, research, commentary, market data and analysis, and more than 9,000 price assessments daily that are widely used as benchmarks in the physical and futures markets. In addition, Platts serves customers through two business lines that operate under their own well-established brand names: The Steel Index (TSI), a price information specialist which compiles indexes through the collection of transaction data from industry participants, and BENTEK Energy®, a specialist in natural gas fundamental market data analysis

Standard and Poors
Acquired by Mc-Graw Hill in 1966. S&P Indices, the world's leading index provider, maintains a wide variety of investable and benchmark indices to meet an array of investor needs. Over $1.25 trillion is directly indexed to Standard & Poor's family of indices, which includes the S&P 500, the world's most followed stock market index, the S&P/Case-Shiller Home Price Indices, the leading measure of U.S. home prices, the S&P Global BMI, an index with approximately 11,000 constituents, the S&P GSCI, the industry's most closely watched commodities index, and the S&P National AMT-Free Municipal Bond Index, the premier investable index for U.S. municipal bonds.

S&P Capital IQ, a brand of the McGraw-Hill Companies (NYSE:MHP), is a leading provider of multi-asset class data, research and analytics to institutional investors, investment advisors and wealth managers around the world. It provides a broad suite of capabilities designed to help track performance, generate alpha, identify new trading and investment ideas, and perform risk analysis and mitigation strategies. Through leading desktop solutions such as Capital IQ, Global Credit Portal and MarketScope Advisor desktops; enterprise solutions such as S&P Securities Evaluations, Global Data Solutions, and Compustat; and research offerings, including Leveraged Commentary & Data, Global Market Intelligence, and company and fund research, S&P Capital IQ sharpens financial intelligence into the wisdom today's investors need.

MSCI INC.

Founded in 1969 and listed in 2007, MSCI was until 2009 controlled by Morgan Stanley. MSCI Inc. is a provider of investment decision support tools to investors globally, including asset managers, banks, hedge funds and pension funds. MSCI products and services include indices, portfolio risk and performance analytics, and governance tools. The company’s flagship product offerings are: the MSCI indices; Barra multi-asset class factor models, portfolio risk and performance analytics; RiskMetrics multi-asset class market and credit risk analytics; ISS governance research and outsourced proxy voting and reporting services; FEA valuation models and risk management software for the energy and commodities markets; and

CFRA forensic accounting risk research, legal/regulatory risk assessment, and due-diligence.

MSCI is headquartered in New York, with research and commercial offices around the world.

Dow Jones
Founded in 1882, News Corp. acquired Dow Jones in December 2007. Dow Jones Indexes is a leading full-service index provider that develops, maintains and licenses indexes for use as benchmarks and as the basis of investment products. Best-known for the Dow Jones Industrial Average, Dow Jones Indexes offers more than 130,000 equity indexes as well as fixed-income and alternative indexes, including measures of hedge funds, commodities and real estate. . Dow Jones Indexes is part of a joint venture company owned 90 percent by CME Group Inc. and 10 percent by Dow Jones & Company, Inc., a News Corporation company

STOXX
STOXX Limited is an established and leading index specialist with a European heritage. The launch of the first STOXX® indices in 1998, including the EURO STOXX 50® index, marked the beginning of the STOXX success story, based on the neutrality and independence of STOXX. Since that time, STOXX has been at the forefront of market developments, continuously expanding its portfolio of innovative indices, and now operates on a global level, across all asset classes. The indices are licensed to the world's largest issuers of financial products, capital owners and asset managers as well as to more than 400 companies around the world, and are used not only as underlyings for financial products such as exchange-traded funds (ETFs), futures and options, and structured products, but also for risk and performance measurement.

STOXX is also the marketing agent for the indices of its shareholders Deutsche Börse AG and SIX Group AG, among them the DAX and SMI indices

Argus Media Limited
Argus is a privately held UK-registered company headquartered in London . Argus is a leading provider of price assessments, business intelligence and market data for the global crude oil, petroleum products, gas, LPG, coal, electricity, biofuels, biomass, emissions, fertilizer and transportation industries.

Argus’ proprietary assessments of open-market physical commodity prices are used as price references in long-term supply contracts for physical commodities, as independent references for taxation purposes, as underlying indexes for commodity derivatives, and for a wide range of investment and market analysis purposes.

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Exchanges around the world that use FTSE tinclude ATHEX, Bolsas y Mercados Españoles, Borsa Italiana, Bursa Malaysia, Casablanca SE, Cyprus Stock Exchange, IDX, JSE, LSE, NASDAQ Dubai, NYSE Euronext, PSE, SGX, Stock Exchange of Thailand and TWSE.