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Mr Steven Maijoor
Chairman
European Securities and Markets Authority
103 Rue de Grenelle
75007 Paris
France

Mr Andrea Enria
Chairman
European Banking Authority
Tower 42 (Level 18)
25 Old Broad Street
London EC2N 1HQ
United Kingdom

Re: ESMA and EBA Consultation Paper on Principles for Benchmarks-Setting Processes in the EU

Dear Mr Maijoor and Mr Enria,

We appreciate the opportunity to provide the European Securities and Markets Authority ("ESMA") and the European Banking Authority ("EBA") with our views on the Consultation Paper on Principles for Benchmarks-Setting Processes in the EU (the "Consultation"). The objective of the Consultation, which was prepared by the Joint EBA-ESMA Task Force on Principles for Reference Rates and other Benchmarks-Setting Processes in the EU ("Task Force"), is to establish Principles focused on reference rates and other benchmarks setting processes in the EU "in light of the susceptibility of benchmark categories to conflicts of interests or manipulation as well as their importance to financial market activity, the real economy and investor protection."

The Vanguard Group, Inc. ("VGI") began operations in the US in 1975 and is headquartered in Valley Forge, Pennsylvania, USA. Today VGI (together with its affiliates, as appropriate, "Vanguard") operates in Europe, Asia, Australia and Canada. In Europe, Vanguard Asset Management Limited ("VAM") has offices in London, Paris, Amsterdam and a sister office in Zurich, Switzerland. Vanguard aims to offer investors the highest value investment products and services available, and is one of the world's largest and most respected investment management companies, managing more than US\$ 2.4 trillion in assets worldwide (as at 31 January 2013), the majority of which is invested in index tracking funds. Vanguard's model is to keep costs low and provide clarity and communicate candidly with investors in relation to investment risks, costs and potential rewards, in keeping with Vanguard's "plain talk" philosophy. Vanguard does not pay third parties to distribute its funds, but instead works with fee based investment professionals who appreciate this cost-based investment approach.



As one of the world's largest users of indices, Vanguard has a significant interest in the issue of benchmark credibility and integrity. Worldwide, Vanguard manages more than 150 index tracker funds, ETFs, and separately managed accounts, with aggregate assets of more than US\$ 1.6 trillion. In Europe, VAM manages 32 index tracker funds, ETFs and separately managed accounts, with aggregate assets of more than US\$ 35 billion. These vehicles seek to track the performance of equity indices sponsored by FTSE, MSCI, S&P, Russell, Mergent and the Center for Research in Securities Prices ("CRSP"), and fixed income indices sponsored by Barclays and UBS. Vanguard also manages more than 65 actively managed funds, with assets of more than US\$ 700 billion; these funds use various indices as benchmarks to help investors compare a fund's performance to the performance of a particular market or market sector as measured by an index. (All data as at 31 January 2013.)

In this regard, we would point the Task Force to the consistent responses that Vanguard has made in respect of the regulation of indices to: (i) the European Commission's Consultation Document on the Regulation of Indices on 29 November 2012¹; and (ii) IOSCO's Financial Benchmarks Consultation Report on 14 February 2013. We welcome that the Task Force states in the Consultation that the Task Force Principles "will be aligned with the principles that IOSCO will develop"².

The Task Force was created in the wake of the scandal over the alleged manipulation of LIBOR and related benchmarks. The Task Force, through the Consultation, has attempted to address a wide range of benchmark-related issues, rather than the more narrow issues raised by the scandal. Unfortunately, in attempting to be comprehensive, the Task Force has, in our opinion, attempted to do too much.

The scope of the Consultation is too broad

In response to Question 1 of the Consultation, the primary problem with the Consultation is that the definitions of "benchmark" and "benchmark user" are too wide. As a result, the Consultation lumps all "benchmarks" together and assumes that all are in some need of regulatory oversight. Vanguard disagrees. We draw a distinction between, on the one hand, indices that simply measure the performance of publicly traded assets such as stocks or bonds ("market indices"), and, on the other hand, benchmarks such as LIBOR that rely on voluntary submissions of information not based on actual transactions. We note that the Task Force itself recognizes that "...in the case of market indices...methods of data collection and calculation are highly heterogeneous and vary widely".

¹ See http://ec.europa.eu/internal_market/consultations/2012/benchmarks/individual-others/vanguard_en.pdf

² We welcome such coordination and consistency as the provision of index services is a global industry. Indeed, we foresee that any interim measures introduced by the Task Force may have global implications for index providers. It seems unlikely that global index providers (such as MSCI, FTSE, S&P, etc.) will apply multiple regional sets of standards for methodology, transparency, governance, etc. Effectively, this may mean index providers applying any ESMA-EBA Principles introduced on a temporary global basis and subsequently revising their procedures to take account of later regulatory developments emanating from IOSCO and the European Commission. We would hope that a coordinated and consistent approach by interested parties could help prevent this.

Market indices, with minor exceptions, use construction methodologies based on objective (and published) rules. Periodic reconstitutions of the indices follow the rules and generally are announced in advance of their effective dates. The underlying data used to calculate daily index levels are based on objective data – actual transaction prices or, as is sometimes the case for fixed income indices, actual and actionable quotes. In most cases, these data are supplied to index calculation agents by independent third party data providers. These standards stand in stark contrast with LIBOR, which is calculated based on estimates of interbank borrowing rates submitted by parties that could have a financial interest in the calculated rate. In short, market indices generally are not subject to covert manipulation that could call into question the integrity of the indices, and therefore the imposition of regulatory oversight over such indices is not warranted.

As indicated above, Vanguard is a prolific user of market indices from many different global index providers. We also are a fiduciary on behalf of our funds' shareholders. If we believed that regulation of index providers, or even of index users such as our funds, would meaningfully and cost effectively add to the protection of fund shareholders, we would heartily endorse such efforts. In reality, we believe that such efforts are unnecessary and potentially even counterproductive.

Regulation of market indices and their providers is unnecessary

In response to Questions 2, 3 and 5 of the Consultation, Vanguard does not consider that regulatory principles applicable to market indices and their providers is necessary because (a) the manner in which market indices are constructed makes them difficult to manipulate, and (b) market index providers have an overwhelming incentive to police the integrity of those indices.

Market indices are difficult to manipulate. First and foremost, index levels are calculated based on the quoted prices of publicly traded stocks and bonds, and most indices reference hundreds (and in some cases even thousands) of individual issues. Manipulating the price of a market index through intervention in the underlying markets would be exceedingly difficult and costly and almost certainly would be noticed by regulators and market participants. And although theoretically it might be possible for an insider at an index provider (or at an independent third party calculation agent) to manipulate the price of a market index by publishing an inaccurate price level, index providers have a strong incentive to police the integrity of their indices, as discussed below, and in any event such manipulation would be apparent given that the inputs that determine the index's price level (stock and bond prices and quotes) are public.

Market index providers have an overwhelming incentive to police the integrity of their indices through imposition of robust control processes. The business of providing investment indices is both profitable and extremely competitive. Index users can change indices at will. Consequently, if an index provider were suspected of manipulating, or failing to prevent a third party from manipulating, the composition or price level of an index, the provider would quickly lose most or all of its business. To prevent such an occurrence, providers expend a great deal of effort and money to ensure that the quality and integrity of their indices are of the highest order.



UCITS and their managers are already subject to a significant number of regulatory requirements in respect of the use of market indices. For example: (i) Article 53 of Directive 2009/65 sets out criteria that a stock or debt security index must satisfy in order to enable a UCITS to replicate such index; (ii) Article 9 of Directive 2007/16 sets out a number of additional criteria in respect of the diversification, adequacy and publication of financial indices that UCITS may replicate; and (iii) the guidelines on exchange-traded funds and other UCITS issues issued by ESMA, which provide further guidance on index criteria. Regulated entities such as managers of collective portfolios and discretionary investment managers, as fiduciaries of their clients' money, also have an incentive to select only reputable index providers offering credible indices. As a result, managers of collective portfolios and discretionary investment managers engage in a comprehensive due diligence examination that involves a thorough analysis of the index (components, construction methodology, past performance, comparison to similar indices, etc.) and the index provider (experience, personnel, control processes, governance, contingency plans, etc.). This due diligence filters out providers with less than robust control processes and governance and helps ensure that the index selected accurately reflects the market or market sector it purports to measure, is credible and reliable, and is appropriate for the client.

Regulation of market indices and their providers is counterproductive

Regulation of market indices and their providers potentially could be counterproductive because (a) it could increase costs, which likely would be passed through to index licensees, including funds and, ultimately, fund investors, and (b) it could raise barriers to entry into the index business.

Vanguard does not oppose regulation simply because it will raise costs. The key question is whether the benefits to be derived from regulation will outweigh the associated costs. As we noted earlier, we believe regulation of market indices and their providers is unnecessary to address "the susceptibility of benchmark categories to conflicts of interests or manipulation as well as their importance to financial market activity, the real economy and investor protection." In the absence of demonstrable public benefit, we are not inclined to support any regulatory initiative with the potential to raise costs for fund shareholders.

Vanguard is particularly concerned about the possibility that regulation of index providers, including the costs imposed by such regulation, could raise barriers to entry into the indexing business. Such barriers would allow existing index providers to maintain oligopoly pricing, again to the detriment of the average fund investor, and could stifle the development of new and innovative market indices and indexing techniques. In this regard, we note that Vanguard currently is in the process of changing index providers for 22 of its US-domiciled index tracker funds, with assets of more than US\$ 350 billion. Sixteen of those funds, with assets of approximately US\$ 180 billion, will begin tracking indices offered by a new index provider, the CRSP. CRSP is a research center within the University of Chicago's Booth School of Business. The switch not only will save Vanguard fund investors millions of dollars a year, it also is likely to lower index licensing fees for asset managers

generally.³ The emergence of CRSP illustrates the importance of keeping barriers to entry low in the indexing business. Any regulation that makes it materially more costly for providers of market indices to do business, or more difficult for new firms to enter the business, should be avoided unless there is clear evidence that the benefits outweigh the costs.

Conclusion

As we noted at the beginning of this letter, the Consultation is intended to address concerns in respect of the “susceptibility of benchmark categories to conflicts of interests or manipulation as well as their importance to financial market activity, the real economy and investor protection.” However, the Task Force has failed to articulate, in the context of market indices, any tangible concerns that would warrant regulatory oversight, particularly on a temporary basis in advance of possible future legislative proposals by the European Commission. For the reasons set forth herein, Vanguard believes that there are adequate structural and operational controls already in place that help to ensure that market indices are accurate and not subject to manipulation.

Vanguard’s objection to regulatory oversight of market indices should not be construed as an objection to the specific principles articulated in the Consultation, particularly those proposed in respect of “users” (as set out in section F of the Consultation). For example, we agree with the Task Force that a credible benchmark is one that is appropriate, suitable and relevant. We simply believe that providers and users of market indices already meet these standards, making regulatory intervention unnecessary. That said, we generally would support self-governance initiatives to further ensure the credibility and integrity of market indices through, for example, codification of best practices or the adoption by index administrators, calculation agents, and submitters of a code of ethics. In addition, we strongly support the adoption of a broad anti-market abuse provision that applies specifically to the manipulation of any benchmark, including any market index, by its provider or any market participant, such as is envisaged by the proposal for a Regulation of the European Parliament and of the Council on insider dealing and market manipulation (market abuse).

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³ See, e.g., “Vanguard Puts the Squeeze On,” at <http://www.indexuniverse.eu/blog/8567-vanguard-puts-the-squeeze-on.html?Itemid=127> (3 October 2012) (noting that “Vanguard’s switch is likely to result in other index licensees queueing up for fee cuts”).



Thank you for the opportunity to comment on the Consultation. If you would like to discuss these comments further, you can contact either me at jeffrey.molitor@vanguard.co.uk or Barry Mendelson, Principal and Senior Counsel at barry_mendelson@vanguard.com.

Sincerely,

A handwritten signature in blue ink, appearing to read "J Molitor", with a long, sweeping horizontal line extending to the right.

Jeffrey Molitor
Chief Investment Officer, Vanguard Europe

cc: Heidi Stam, Managing Director and General Counsel, Vanguard
Richard Wane, Principal and International Legal Counsel, Vanguard