

MEMORANDUM

TO: File Nos. S7-18-22; S7-17-22; S7-03-22

FROM: Ted Uliassi
Senior Counsel, Division of Investment Management

RE: Conference On Emerging Trends In Asset Management

DATE: June 14, 2023

On May 19, 2023, the Division of Investment Management of the Securities and Exchange Commission (“SEC”) hosted a Conference on Emerging Trends in Asset Management (“Conference”). A webcast of the Conference is available here:

<https://www.youtube.com/watch?v=I19TaFvTGn4>;
https://www.youtube.com/watch?v=o_Gmc_3x038;
https://www.youtube.com/watch?v=7JPE_DJKmvs.

Several SEC staff members, asset management industry participants, and academics—including those listed as speakers, session moderators, or panelists on the Conference agenda (<https://www.sec.gov/news/upcoming-events/conference-emerging-trends-asset>)—participated in the Conference.

The Conference participants discussed, among other things, the SEC’s request for comment titled *Request for Comment on Certain Information Providers Acting as Investment Advisers* (Release Nos. IA-6050; IC-34618) and the SEC’s proposals titled *Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices* (Release Nos. 33-11068; 34-94985; IA-6034; IC-34594) and *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews* (Release No. IA-5955).

A participant submitted the attached materials.

Investment Complexity & Outsourced Services: Indices & Financial Data

Adriana Z. Robertson
University of Chicago Law School

May 19, 2023



THE UNIVERSITY OF CHICAGO
THE LAW SCHOOL

Roadmap



1. The role of index providers
 - ▶ Substantively, the relationship often looks like that of a subadviser
2. “Closet activeness” of “passive” funds
 - ▶ Many indexed ETFs and open ended index mutual funds are very active (based on conventional measures)
 - ▶ More active index funds & ETFs ⇒ worse performance
3. Commercial (and quasi commercial) data providers
 - ▶ The complex role of ESG ratings
 - ▶ The role of academic data ⇒ Fama-French data & its murky provenance

Indices as Advisers

A Spectrum of Index Funds / ETFs



Traditional conception: The fund tracks a well-known pre-existing index

- ▶ Ex. S&P 500, Russell 2000



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With the rising number of specialized index funds / ETFs, this dynamic has shifted

- ▶ The fund sponsor asks the index provider to create an index to her specifications
- ▶ The fund tracks the index in exchange for a licensing fee
- ▶ The index has no real purpose beyond determining the portfolio of the fund that tracks it



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Question: Is the index provider an investment adviser under the securities laws?



Definition of Investment Adviser

Investment Advisers Act (1940), Section 202(a)(11)

- ▶ “Investment adviser” means 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 who, for compensation and as part of a regular business, **issues or promulgates analyses or reports** concerning securities

... but does not include ...

- ▶ (D) the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation



Our View

Providing a list of securities (with associated weights!) with the intent or understanding that an investor will use it to assemble a portfolio constitutes “advice”

This is consistent with the SEC’s broad interpretation of “advice,” including:

- ▶ implicit advice is sufficient to trigger regulation
- ▶ providing something that, in practice, could operate as a portfolio selection tool can constitute “advice”
- ▶ “providing a selective list of securities is advice about securities even if no advice is provided as to any one security.”

Publisher's Exclusion & Personalized Advice



The crux of the publisher's exclusion is whether the advice is general or personalized to the client

See, e.g. *Lowe v. SEC*, 472 U.S. 181 (1985)

- ▶ “As long as the communications between petitioners and their subscribers remain **entirely impersonal** and do not develop into the kind of fiduciary, **person-to-person relationships** that were discussed at length in the legislative history of the Act and that are characteristic of investment adviser-client relationships, we believe the publications are, at least presumptively, within the exclusion and thus not subject to registration under the Act.”

Punchline



We think it is clear that the providers of specialized indices are Adviser under the Advisers Act

- ▶ There is similar (albeit not identical) language in the Investment Company Act (1940)
- ▶ These index providers are analogous to subadvisers

Our suggestion: A non-exclusive safe harbor for index providers that do not provide personalized indices

- ▶ The safe harbor could include modest disclosure and operational requirements
- ▶ An index provider that does not qualify would be deemed a sub-adviser for purposes of the 40 Act & an investment adviser under the Advisers Act

Activeness of “Passive” Funds



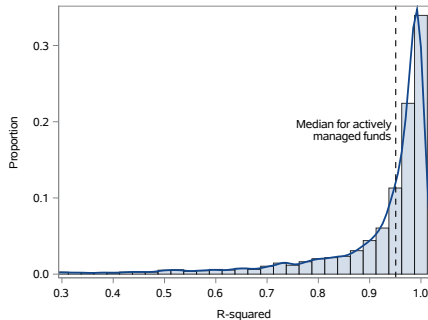
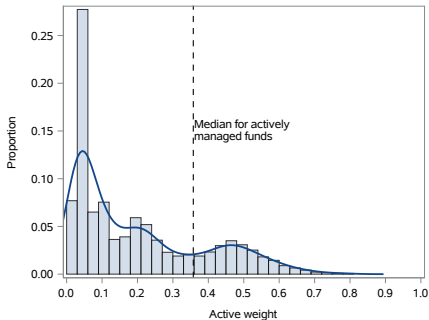
How “Active” Are Index Funds & ETFs?

To answer this, we

- ▶ Assembled a database of all index ETF and index funds (2006-2018)
- ▶ Obtained and reviewed the Form N-1A for each year
- ▶ Constructed two standard measures of “activeness” from the finance literature
- ▶ Based on these measures, how active are index funds & ETFs relative to actively managed funds?

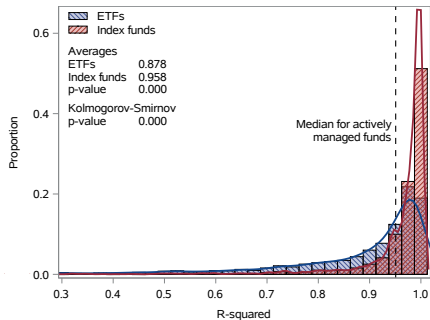
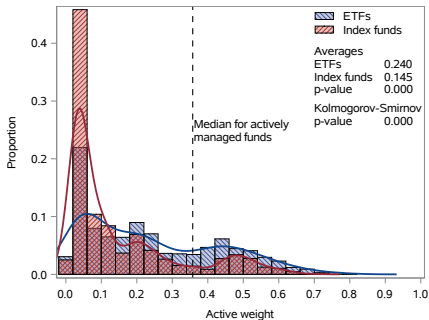


Activeness: All Index Funds & ETFs



- ▶ “Passive” funds exhibit substantial levels of activeness
 - ▶ **22%** of fund-years exhibit more AW than the median active fund; **38%** have lower R^2

Activeness: Index Funds v ETFs?



- ▶ Effects are present **in both index funds and ETFs**
 - ▶ Though ETFs do exhibit more activeness



Do “Closet Active” Funds Perform Differently?

To answer this, we

- ▶ Estimate standard performance regressions
- ▶ Outcome variables: Annual Sharpe ratio & Annualized four-factor alpha
- ▶ Key independent variables: measures of activeness \Rightarrow Active weight, $1-R^2$, proprietary indicator

More Active Index Funds / ETFs \Rightarrow Worse Performance



	Dependent Variable											
	Alpha						Sharpe ratio					
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
A. All funds												
1 - R ²	-1.267 [-2.53]	-1.207 [-2.50]					-0.282 [-1.91]	-0.269 [-1.85]				
Active weight			-3.165 [-4.39]	-3.007 [-4.65]					-0.604 [-3.13]	-0.505 [-3.29]		
Proprietary					-0.796 [-2.23]	-0.741 [-2.16]					-0.097 [-2.18]	-0.076 [-1.86]
Log TNA		0.098 [1.65]		0.041 [0.53]		0.082 [1.15]		0.021 [1.74]		0.026 [2.00]		0.033 [2.25]
Observations	6,933	6,933	6,468	6,468	7,258	7,258	6,955	6,955	6,486	6,486	7,283	7,283
R-squared	0.024	0.024	0.017	0.017	0.016	0.016	0.748	0.749	0.734	0.735	0.731	0.733

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- ▶ One-SD increase in AW \Rightarrow 0.092 unit lower SR (alpha \downarrow 55 bps)
- ▶ One-SD increase in $1-R^2$ \Rightarrow 0.037 unit lower SR (alpha \downarrow 17 bps)
- ▶ Proprietary funds \Rightarrow 0.076 unit lower SR (alpha \downarrow 74 bps)
 - ▶ Patterns are generally negative, although statistical significance is weaker for some variables

Other Data Providers

ESG Ratings



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The resulting industry has been heavily criticized:

- ▶ Methodologies differ across providers
- ▶ ESG ratings have low correlations across providers
- ▶ Methodologies change over time



A Recent Example

Over 30,000 Funds to Get Their ESG Ratings Downgraded at MSCI

- Swap-based ETFs will remain eligible for ESG ratings: MSCI
- Overhaul follows widespread criticism of ESG ratings industry

By [Natasha White](#) and [Frances Schwartzkopff](#)

March 30, 2023 at 3:41 AM CDT *Updated on March 30, 2023 at 8:35*

AM CDT

Some 31,000 funds are about to have their ESG scores lowered at [MSCI Inc.](#), as the firm's ratings unit works through a major overhaul of its methodology in response to feedback from market participants.

Challenges



Whether this is a feature or a bug depends upon one's perspective

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Bullish view:

- ▶ ESG is a broad and diverse concept \Rightarrow ratings may diverge because people disagree
- ▶ ESG is relatively new \Rightarrow we should expect innovation in the market

Bearish view:

- ▶ If investors can't distinguish between ratings providers, how can they evaluate their options?
- ▶ The line between asset managers and ratings providers (and index providers) becomes blurry

Problematic (Quasi-) Academic Data



Factor models are ubiquitous in finance

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- ▶ **Fama-French** factors & data are a “gold standard” approach



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We document substantial **retroactive changes** in the standard data source

- ▶ These changes **materially affect estimates** of performance
- ▶ The changes do not appear to be making the factors “better”
- ▶ The bulk of the changes after the mid-1960s are driven by **intentional changes**



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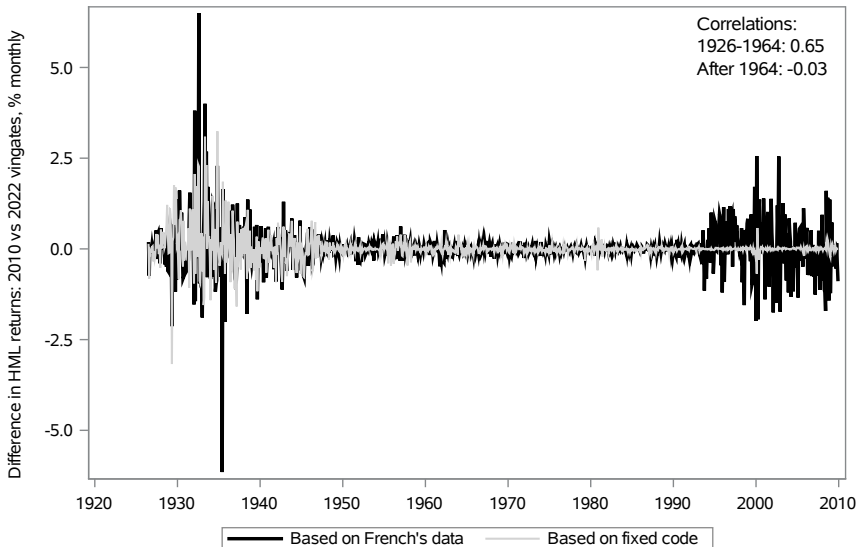
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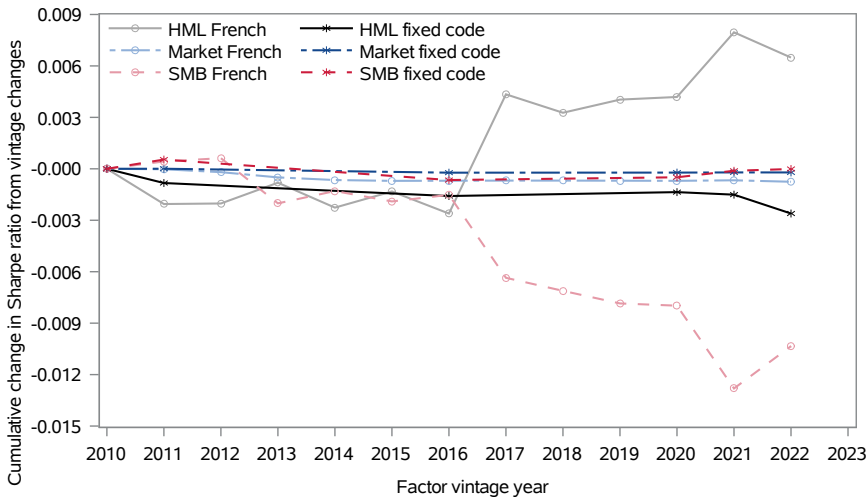
The provenance of the data is not fully disclosed, but DFA appears to have some involvement



Data Changes v Code Changes



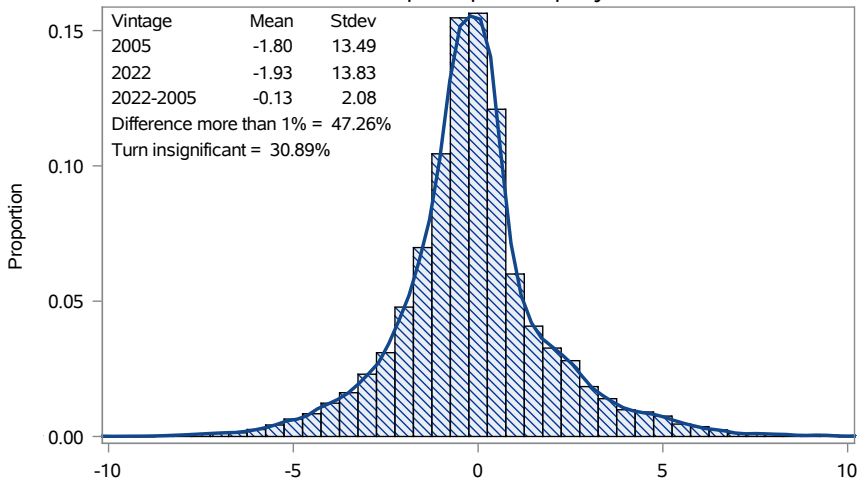
Impact of Changes



Mutual Fund Alphas from Different Vintages



A. Differences in alphas, percent per year





Conclusion



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- ▶ For practical purposes, index providers are the entities responsible for selecting the portfolios of index funds & ETFs
 - ▶ In many cases, they appear to be *de jure*, not just *de facto* investment advisers
- ▶ A large proportion of index funds & ETFs follow highly active strategies
 - ▶ These more active index funds & ETFs tend to perform poorly
- ▶ Other types of data providers
 - ▶ ESG ratings have been criticized \Rightarrow more work is needed to know whether there is a real problem here
 - ▶ Serious concerns about the integrity of the standard “Fama-French” data

