ADVISERS BY ANOTHER NAME

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The rise of index funds has reshaped the modern American capital markets. Like mutual fund managers, indices now direct trillions of dollars of investor capital. Although it regulates mutual fund managers as investment advisers, the SEC has chosen not to treat the providers of market indices similarly.

In this Article, we argue that many index providers are not merely like investment advisers; under the relevant statutory and regulatory regimes, they are investment advisers. The SEC's failure to recognize this fact reflects an inaccurate and antiquated view of the index fund market.

Having established that certain index providers are presently acting as unregulated investment advisers, we propose a regulatory solution. The SEC should create a nonexclusive, conditional safe harbor giving index providers guidance on what activities will and will not make them investment advisers. This would close the regulatory gap in a way that is consistent with the governing statutes and case law without unduly burdening market participants.

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Introduction

In August 2019, the assets managed by index funds overtook those managed by actively managed funds for the first time.[1] It was not a surprising development. On average, index funds charge lower fees and expenses than actively managed funds. While active managers attempt to outperform broad market indices, there is scant evidence that they do so on average.

As the name suggests, an index fund attempts to track (not beat) the performance of an index such as the S&P 500 or Russell 2000 or one of a large number of more specialized indices. But this is not the same thing as saying that index investing is purely mechanical and passive. An index provider periodically adds or drops stocks from the index and adjusts the weights of the component stocks. In doing so, the index provider often exercises discretion, which affects fund returns. Research suggests that in some cases, the discretionary component of a supposedly passive fund can be substantial.[2] In effect, index funds delegate stock selection to the index manager.[3]

Professionals who advise investors on portfolio selection are subject to regulation under the Investment Advisers Act of 1940 (IAA) and, if the client is a mutual fund, exchange-traded fund, or similar entity, under the Investment Company Act of 1940 (ICA). Among other things, the statutory scheme subjects the investment adviser to registration with the SEC, recognizes that the adviser owes fiduciary duties to its clients, and regulates transactions between a fund and its adviser. The SEC has not, however, taken the position that index providers are investment advisers to the index funds that license and track their indices.

In this Article, we argue that many index providers constitute investment advisers. This may seem odd if one's frame of reference is the S&P 500 index or a handful of other well-known broad market indices, which dominate the market for index investing and the related public and academic discourse. These indices also serve as benchmarks for non-indexed strategies; in other words, they are a yardstick by which many active managers are measured.[4] We refer to these as "general" indices because of their multiple uses and widespread adoption in the market.

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[1] John Gittelsohn, *End of Era: Passive Equity Funds Surpass Active in Epic Shift*, Bloomberg, (Sep. 11, 2019, 11:21AM), https://www.bloomberg.com/news/articles/2019-09-11/passive-u-s-equity-funds-eclipse-active-in-epic-industry-shift.

[2] *See* David Easley et al., *The Active World of Passive Investing,* 2 (Oct. 26, 2020) (unpublished manuscript) (available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3220842).

[3] *See* Adriana Z. Robertson, *Passive in Name Only: Delegated Management and Index Investing*, 36 Yale J. on Reg. 795, 798 (2019).

[4] *See generally* Berk A. Sensoy, *Performance evaluation and self-designated benchmark indexes in the mutual fund industry*, 92 J. Fin Econ. 25 (2009) (noting that mutual funds must report their performance relative to a benchmark, and finding evidence that investors respond to a fund's performance relative to their benchmark).

Often overlooked in the discussion of index funds is the role of indices explicitly designed and created to be tracked by index funds. The thousands of publicly offered U.S. index funds track hundreds of different indices. Many of these indices are tracked by a single fund.[5] Unlike the S&P 500 or the Russell 2000, which are intended to capture the universe of large-cap and small-cap companies, respectively, these indices are typically not designed to represent a broad "market." Instead, they represent a smaller and self-defined subset of companies in a particular industry or market segment, a set of stocks or companies with some particular characteristics, or some other set of stocks selected by the index provider on some basis. We refer to these as "single purpose" indices in light of their more focused use.

Single purpose index providers should generally constitute investment advisers to the relevant funds under the IAA and ICA as interpreted by the federal courts. These providers resemble active managers in the sense of selecting securities for a particular client to meet that client's individualized needs.

The appropriate regulatory treatment of general indices is less obvious. Their proprietors represent themselves as data publishers rather than stock-pickers.[6] That is, they make generally available to subscribers a list of companies and index weights that is not tailored to the needs of any particular subscriber, an activity that the regulatory system does not treat as investment advice.

This argument is valid as far as it goes. To receive regulatory treatment as a publisher, however, an entity must avoid conflicting interests, such as investing or trading in securities on which it reports or receiving compensation from an issuer to report on its securities. It must also refrain from tailoring its reporting to the needs of individual customers.

The SEC could—and we believe should—distinguish those advisers that constitute investment advisers and those that constitute data publishers through a safe harbor rule. To qualify as a publisher, the relevant index should be non-personalized. Providers of single purpose indices would therefore generally constitute investment advisers. As we discuss in more detail below, they should be treated similarly to sub-advisers, with disclosure and other duties tailored to their role.

Index providers desiring treatment as publishers should also be subject to independence standards designed to ensure that the index providers avoid conflicting interests. Finally, whether treated as an adviser or publisher, an index provider's licensing fee should be disclosed in the relevant fund's prospectus. Under current practice, it may be bundled together with other administrative expenses.

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[5] *See* Robertson, *supra* note 3, at 812–13.

[6] For example, the "Data and Index Licensing" section of the S&P Dow Jones Indices web page describes "indices and associated data packages" as the unit to be licensed. *See Data & Index Licensing*, S&P Dow Jones Indices, https://www.spglobal.com/spdji/en/about-us/data-index-licensing (last visited December 30, 2020).

In addition to being faithful to the statutory scheme, we believe such a rule would benefit investors. It would make licensing fees, and therefore the cost of stock selection through an index, more transparent. It would also ensure that an index provider's discretionary decisions are not the product of conflicting interests.

Achieving these goals would not impose a significant burden on index providers. Major index providers, such as S&P Dow Jones Indices, already have in place policies designed to ensure independent decision-making in the design and composition of indices.[7] We also note that general index providers with a global reach are already subject to registration and conflict of interest regulation under EU law.[8]

One might turn the argument on its head and contend that the modest additional compliance cost suggests that there is no regulatory problem to be solved. We will demonstrate that there is a *potential* for index providers to exercise their discretion in self-interested ways. This potential has not to date generated widespread abuses.[9] Why shouldn't the SEC refrain from acting unless and until abuses occur?

We have two responses. First, the SEC's regulation and oversight of investment advisers either adds value or it doesn't. For the purposes of this Article, we take the existing system of investment adviser regulation as given and simply argue that it should be applied evenhandedly to everyone meeting the relevant criteria. If the operation of index funds suggests that market mechanisms are sufficient to discipline fund managers and that substantial parts of the IAA and ICA are unnecessary, that is an important observation, but one for another day.

Second, the growing popularity of index investing is creating a gray area between the classic index fund and actively managed funds. Single purpose indices are the leading edge of the gray area, but not necessarily the end point. At some point, the SEC may confront an active manager that claims to be an index provider for marketing purposes. If the SEC takes the categorical stance that index providers are not investment advisers, then that manager will avoid the fiduciary duties inherent in the traditional advisory relationship. Given the relative simplicity of the underlying issues, it would be better to have a framework in place sooner rather than later.

The remainder of this Article proceeds as follows. In Part I, we discuss the current state of the index fund market, with particular emphasis on the relationship between index providers and fund sponsors. In Part II, we provide an overview of the regulation of investment advisers under the IAA and the ICA. We combine the analyses in the prior two Parts in Part III and ask whether the providers of indices that index funds track are properly classi-

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[7] *See, e.g.*, *Governance*, S&P Dow Jones Indices, https://www.spglobal.com/spdji/en/governance (last visited December 30, 2020).

[8] *See* Council Regulation 2016/1011, 2016 O.J. (L 171) 1.

[9] This is not to say there have been no abuses at all. *See infra* Part I.B.

fied as investment advisers under the current statute, judicial precedent, and SEC interpretations. We conclude that there is a strong case for treating the providers of single purpose indices as investment advisers. With respect to general indices, the conclusion depends on how the index provider operates. In light of the interpretive ambiguity and the investor protection challenges raised by the current regulatory gaps, we conclude that the SEC would be well advised to produce clarifying rules and safe harbors for these index providers. We present such a regulatory proposal in Part IV.

I. Index Providers as Portfolio Managers

A securities index is traditionally viewed as a means to conveniently summarize the behavior of some market at a given point in time. As such, an index can be used for many different purposes: as a comparator (commonly referred to as a benchmark), as an input into a pricing formula (for example, in a long-term supply contract), or simply as a piece of information that market participants might like to have for their planning or decision-making purposes. These traditional uses can be loosely described as informational: the index return on a given day provides market participants with useful information that they can rely on in going about their business.

Concretely, a securities index can be thought of as a list of securities intended to capture "the market." This list contains two columns—in the first, the identity of each security; in the second, the weight associated with that security. At the close of trading, the index creator takes the return of each security, multiplies each by its respective weight, and then adds them all up. This generates the return of the index on that day. Because the securities and weights are intended to capture the relevant market, the resulting return is taken to be a good approximation of the behavior of that market on that day.

A. The Rise of Index Funds

While indices continue to play their traditional informational role, a new and qualitatively different role has emerged over the past two decades. Increasingly, indices are used for "passive," or index, investing by way of index funds. The defining feature of these funds is that their portfolios are designed to mimic the constituents of the relevant index. Since the index is constructed from a list of constituents and weights, the fund will simply form a portfolio that consists roughly of these same securities in proportions that are approximately the same as those weights. The "roughly" and "approximately" allow for the fact that the fund's portfolio might deviate from the index slightly for a variety of practical (and sometimes strategic) reasons.

The basic idea behind index funds is that active managers, who select individual stocks based on some investing strategy, don't systematically outperform relevant market benchmarks. By investing in an index fund, the investor "buys" the benchmark rather than trying to beat it, thereby getting low-cost diversification without sacrificing returns. What started out in 1976 as a single fund with a paltry eleven million dollars in assets under management[10] has since grown into a multi-trillion-dollar market. By the end of 2019, the dollar value of assets invested in domestic equity index funds had overtaken that of actively managed domestic equity funds.[11] Index funds also account for an increasingly large portion of other markets and asset classes, such as global equities and hybrid and bond funds.[12]

The index fund market has also grown in complexity over the years. In addition to large index funds managing hundreds of billions of dollars, there has been an explosion in the number of smaller and more specialized funds tracking specialized indices. These underlying indices are not designed to track "the market" at all, at least not in the traditional sense of the term. Instead, as we describe in more detail in Part I.B, they consist of a defined subset of stocks unrepresentative of the broader market. The implicit thesis is that holding a portfolio in which these stocks are over-represented can help the investor to outperform the market or achieve some other investment goal. In short, it blurs the line between index investing and active management.

The rise of Exchange-Traded Funds (ETFs) has also contributed to the growth of index investing. An ETF is a particular kind of open-end investment company that trades on a secondary market like a closed-end fund.[13] While actively managed ETFs exist,[14] the overwhelming majority track an index of one kind or another.[15] ETFs are therefore commonly described as a

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[10] Robin Wigglesworth, *Jack Bogle, Index Fund Pioneer, 1929-2019*, FINANCIAL TIMES, (Jan. 16, 2019), https://www.ft.com/content/91054b00-19dd-11e9-9e64-d150b3105d21.

[11] John Gittelsohn, *End of Era: Passive Equity Funds Surpass Active in Epic Shift*, BLOOMBERG, (Sep. 11, 2019, 11:21 AM), https://www.bloomberg.com/news/articles/2019-09-11/passive-u-s-equity-funds-eclipse-active-in-epic-industry-shift.

[12] INV. CO. INST., 2020, INVESTMENT COMPANY FACT BOOK 84 fig. 4.2., https://www.ici.org/pdf/2020_factbook.pdf. For a detailed account of the index fund market, including the institutional context in which these funds operate, see generally Jill E. Fisch, Assaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17 (2019). For a discussion of the growth of the three largest asset managers, with specific focus on their index fund offerings, see generally Scott Hirst & Lucian A. Bebchuk, *The Specter of the Giant Three*, 99 B.U.L. REV. 721 (2019).

[13] Because of their hybrid nature, ETFs require regulatory relief under the ICA. Initially, this came in the form of SEC exemptions, but more recently, the SEC adopted a rule governing the operation of ETFs. Exchange-Traded Funds, 84 Fed. Reg. 57,162, 57,163 (Oct. 24, 2019) (to be codified at 17 C.F.R. pt. 210, 232, 239, 270, 274) (noting that "ETFs currently rely on exemptive orders, which permit them to operate as investment companies under the [Investment Company] Act [of 1940]"). On October 24, 2019, the SEC adopted rule 6c-11 under the Investment Company Act of 1940, which created a regulatory framework for ETFs. *Id.*

[14] Exchange-Traded Funds, 84 Fed. Reg. 57,162, 57,168 at note 55 (Oct. 24, 2019) (noting that as of December 31, 2018, there were approximately $72 billion in assets in actively managed ETFs).

[15] A related, albeit less popular, form of pooled investment vehicle is the unit investment trust (UIT). Unlike ETFs, UITs are a distinct category of investment company under the ICA. *See generally* Unit Investment Trusts (UITs), U.S. SEC. & EXCH. COMM'N, https://

type of index fund. As of December 2019, approximately $4.4 trillion was invested in ETFs in the United States.[16] Across all types of funds and all asset classes, the total value of assets invested in US index funds (including ETFs) was about $8.5 trillion as of December 2019.[17]

While index funds are often characterized as "passive," this does not imply that no one is selecting the stocks in the fund's portfolio. As a logical matter, *someone* has to decide how to allocate the capital invested in an index fund. In practice, this occurs in two steps. The fund's sponsor decides that the fund will track a specified index. The index provider then licenses the index to the fund and, as a practical matter, selects the stocks or other assets in which the fund will invest.

To the extent that an index fund faithfully adheres to its objective of closely matching the return on a specified index, the fund's portfolio will consist largely of the same securities and weights as the index.[18] The fund's portfolio will change as the index provider changes or reweights the constituent securities. Any decision or change at the index level will have a direct and immediate effect on the fund's portfolio because, for all practical purposes, the index determines that portfolio, at least until such time as the fund's managers decide to change its investment strategy.

This observation—that the portfolio of an index fund is determined by the provider of the index that it tracks—does not rely on any facts about the behavior or governance of any particular index. Instead, it follows from the fact that the fund's express goal is to track some pre-determined index. That fact sets investors' expectations for the composition of the portfolio.

Seen in this light, the fact that the index provider determines the fund's portfolio is a feature of index investing, not a flaw. Investors would have cause to object if a fund holding itself out as an index fund held a portfolio that differed materially from that of the underlying index, since such a deviation from the fund's investment strategy would be misleading to its investors. Although an index provider might use a different decision-making process from that of a typical active manager, it nevertheless determines—or selects—the fund's portfolio.

Index providers are compensated for their work by licensing fees paid, directly or indirectly, by the index fund. License fees are operating expenses of the fund reflected in its expense ratio. However, because the SEC does not consider index providers to be advisers, license fees are not management

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www.investor.gov/introduction-investing/investing-basics/glossary/unit-investment-trusts-uits (providing a short summary of the key attributes of UITs).

[16] *ETF Assets and Net Issuance,* Inv. Co. Inst (Jan. 28, 2021), https://www.ici.org/research/stats/etf/etfs_01_21.

[17] Inv. Co. Inst., *supra* note 12, at 38.

[18] Index funds may deviate somewhat from the securities in the underlying index based on cost considerations. They may also use derivative instruments in lieu of certain securities.

fees and not separately disclosed.[19] This makes the disclosed management fees of active and index managers not entirely comparable.

The rise of index funds means that for a multi-trillion-dollar portion of the fund market, the portfolio allocation decisions are made not by the fund's nominal investment adviser, but rather by an index provider, which is compensated for its efforts through a licensing fee. This is a major development in the fund industry that in many ways parallels the rise of mutual fund sub-advisers.

Some fund complexes are organized on a "manager of managers" basis. That is, the primary manager to the complex's funds does not select investments but instead selects managers, known as sub-advisers, who select investments for specific funds or portfolios within funds. A sub-adviser to an actively managed fund provides portfolio selection services to the fund's primary adviser,[20] as does the index provider to an index fund. In either case, delegation allows the fund to pursue an investment strategy that it would not otherwise be able to pursue.[21] Moreover, just as the "brand name" of a well-known index might help an index fund to attract clients, a well-known sub-adviser might provide a marketing advantage for a fund.[22]

Despite these similarities, sub-advisers and index providers are not treated similarly for regulatory purposes. Sub-advisers are considered advis-

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[19] *See Form N-1A: Item 3*, U.S. SEC. & EXCH. COMM'N, (requiring a fee table and describing its contents).

[20] *See* Gregory C. Davis, Rajib Chanda, Renee E. Laws, and Melissa C. Smit, *Mutual Fund Use of Sub-Advisers, in* MUT. FUNDS & EXCH. TRADED FUNDS REG. 42-1, 42-2 to 42-3 (2013) (noting that some mutual funds operate in a "manager of managers" structure, in which the investment adviser hires a sub-adviser and "delegates one or more duties to the sub-adviser pursuant to a sub-advisory agreement, and the investment adviser is obligated to oversee the actions of the sub-adviser." These obligations generally consist of "the portfolio management duties that would typically be provided by an investment adviser in a non-sub-advised fund. In particular, the sub-adviser manages all or a portion of the fund's securities portfolio, including the determination of the purchase, retention, and sale of securities and other investments for the fund, in accordance with the fund's investment objectives, policies, restrictions. This may involve obtaining and evaluating economic, statistical, and financial data and information, and undertaking such additional investment research that is necessary or advisable to manage the investment and reinvestment of the fund's assets. The sub-adviser provides these services subject to the general supervision of the investment adviser and the fund's board of directors, and is often required to report to the board of directors with respect to the implementation of the investment policies of the fund.").

[21] *Id.* at 42-3 ("A mutual fund complex will often use sub-advisers as a means to make new funds available for which it may not previously have had the management capabilities. The use of sub-advisers allows a fund to have an investment focus, style, or objective beyond the particular expertise of the investment adviser's existing staff, helping the investment adviser to fill in gaps in its existing suite of funds without the need for extensive new resources. Sub-advisers also can help a mutual fund complex develop niche products without the investment adviser having to retain highly specialized portfolio managers on staff. In addition, funds may use multiple sub-advisers to diversify investments.").

[22] *Id.* (referencing Jay S. Neuman, Manager of Manager Funds, *2003 Investment Company Regulation and Compliance*, ALI-ABA COURSE OF STUDY (2003)).

ers to funds whose investments they select,[23] whereas index providers are not. As a result, regulatory treatment ultimately depends on the type of third-party entity to which the fund outsources portfolio selection.

B. Index Providers and Security Selection

Because index providers effectively play the role of portfolio managers for the index funds that track them, it is worth investigating the index provider's decision-making process. We begin by briefly describing the landscape of indices.

1. The Landscape of Indices

Index funds are often treated as homogeneous—after all, if index investing is passive, it would make sense that index funds are more or less interchangeable. This is far from the truth. A recent empirical paper,[24] looking exclusively at domestic equity indices that were either being tracked by, or benchmarking, mutual funds available for sale in the United States, documented remarkable diversity among these indices,[25] the bulk of which was found among the indices being tracked by index funds.[26]

The diversity documented in that paper exists across several different dimensions. First, even the universe of domestic equity indices varies widely in objectives and attempts to capture a remarkable array of different "markets" or characteristics. Some focus on a particular size segment (for example, the S&P 500 focuses on large firms while the Russell 2000 focuses on smaller firms), while others target particular "factors" (such as "growth," "low volatility," or "momentum"), and still others pursue what can most simply be described as a specialized strategy (such as the "S&P 500 Catholic Values Index," the "SSGA Gender Diversity Index," or the "WeatherStorm Forensic Account LongShort Index").[27]

In addition, there is often substantial variation across different indices that characterize themselves as targeting the same or similar markets or financial features. For example, the paper documented 169 different domestic equity indices used by index funds that target a "value" or "growth" fac-

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[23] *Id.* at 42-4 ("Generally, the law governing sub-advisers is the same as the law governing investment advisers. When the term 'investment adviser' is used in the Investment Company Act of 1940 . . . it also generally means any sub-adviser.").

[24] *See generally* Robertson, *supra* note 3.

[25] *Id.* at 797.

[26] Authors' investigation of the original data.

[27] Robertson, *supra* note 3, at 824–31.

tor,[28] many of which define "growth" in very different ways.[29] Similarly, different industry-focused indices use different industry classifications.[30]

The degree of detail provided by the publicly available methodology document associated with an index also varies dramatically. Some are skeletal, while others are hundreds of pages long and provide extensive detail as to how the index provider selects and weights securities.[31] Perhaps more importantly, even among indices that provide substantial detail about their process, some retain considerable discretion, to be exercised by the index committee, in selecting securities.

Indices accordingly exist on a continuum. At one end are prominent, well-established indices that are commonly used by market participants for a wide variety of purposes, only one of which is for index investing. These indices have an established reputation in the financial market. Their creators have strong incentives to continue to foster that prominence and maintain that reputation. We refer to these as "general" indices, denoting their wide and diverse uses. Further down the continuum are indices that exist for the purpose of being tracked by an index fund. We refer to these as "single purpose indices." An extreme form of single purpose index is one owned and managed by an affiliate of the fund that tracks it. Because general indices are likely to operate quite differently from single purpose indices, we discuss their approach to security selection separately.

2. Security Selection by General Indices

While general indices usually aim to track a broad market, such as large-cap companies, it does not follow that market participants know their construction ex ante. This is because index selection generally involves the exercise of discretion by the index provider. The resulting regulatory issue is the potential for conflicted or self-interested use of that discretion.

Consider the S&P 500 Index. S&P Dow Jones Indices publishes a detailed methodology, indicating that it adds or subtracts companies from the index based on a set of eligibility criteria that include size, liquidity, and financial viability thresholds.[32] Other criteria, such as the definition of a "U.S. company," explicitly delegate the decision to the index committee in

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[28] *Id.* at 822.

[29] *Id.* at 825–26.

[30] *Id.* at 823 (noting that four different retail industry indices appeared to rely on four different industry classification schemes).

[31] *Id.* at 817–18.

[32] *See* Adriana Z. Robertson, *The (Mis)Uses of the S&P 500*, 10 (Dec. 5, 2020) (unpublished manuscript) (available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3205235); *see also* S&P Dow Jones Indices, S&P U.S. Indices Methodology 10 (Jan. 2021) ("Constituent selection is at the discretion of the Index Committee and is based on the eligibility criteria.").

"ambiguous" cases.[33] Creating and episodically revising the selection criteria is itself an exercise in discretion.

Moreover, the index does not necessarily consist of the 500 largest companies meeting the selection criteria. Instead, "[c]onstituent selection is at the discretion of the Index Committee."[34] The chair of S&P's Index Committee has noted that "there are no rigid or absolute rules for the S&P 500."[35] Recent research has documented that, in practice, the methodology affords substantial discretion to the S&P 500 Index Committee, with discretionary selections accounting for roughly 5% of the total value of the index.[36] When, on November 16, 2020, the Index Committee announced that it would add Tesla, Inc. to the S&P 500 index, Tesla's shares jumped about 9% in after-hours trading. This indicates that market participants could not predict the Index Committee's decision based on publicly available information about Tesla and the selection criteria.[37]

The S&P 500 is by no means unique in this respect. The Dow Jones Industrial Average is even less mechanically constructed. According to the index methodology, "stock selection is not governed by quantitative rules."[38] Instead, a stock from the S&P 500[39] "typically is added [to the Dow] only if the company has an excellent reputation, demonstrates sustained growth and is of interest to a large number of investors . . . . Maintaining adequate sector representation within the index is also a consideration," and changes "are made on an as-needed basis."[40]

Not all general indices reserve the same amount of discretion. For example, while the methodology employed in constructing the Russell family of indices (including the flagship Russell 1000) does allow for amendments to the construction and methodology,[41] itself a form of discretion, it does not contemplate an express stock selection role. The same is true for other indices that are relatively well known, at least in some circles, such as the CRSP indices.

There is nothing prima facie wrong with an index committee exercising discretion. Just as there is nothing wrong with the investment adviser of an actively managed mutual fund selecting which stocks to put into the fund's portfolio, there is nothing wrong with the index provider selecting which stocks will comprise the index.

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[33] *See* S&P U.S. Indices Methodology, *supra* note 32, at 6.

[34] *Id.* at 10.

[35] David Blitzer, *Inside the S&P 500: An Active Committee*, Indexology Blog (Aug. 7, 2014), https://www.indexologyblog.com/2014/08/07/inside-the-sp-500-an-active-committee/.

[36] *See generally* Robertson, *supra* note 32.

[37] *See, e.g.*, Jen Wieczner, *Will Tesla Be Added to the S&P 500? Here's How it Will Be Decided*, Fortune (Jul. 14, 2020, 5:06 PM), https://fortune.com/2020/07/14/tesla-s-and-p-500-index-stock-added/.

[38] S&P Dow Jones Indices, Dow Jones Averages Methodology 5 (Apr. 2019).

[39] *Id.* at 4.

[40] *Id.* at 5.

[41] FTSE Russell, Russell U.S. Equity Indexes Construction and Methodology 8 (Oct. 2019).

The point is that index providers are engaged in stock selection on behalf of clients, a defining characteristic of investment advice. One hallmark of the regulation of investment advisers is fiduciary duties and the concomitant avoidance or disclosure of conflicting interests.

Calling itself an index provider does not mean that a firm is immunized from conflicting interests. All classic conflicts to which an adviser is subject—recommending securities in which the adviser has an interest, accepting side payments for recommending a security, and so on—could in theory affect an index committee's discretionary addition or subtraction of a security from an index.

We can observe conflicting interests affecting the behavior of individual employees. An index manager at S&P, and a member of the index committee, was recently charged with trading on material nonpublic information about the pending addition or subtraction of stocks from indices.[42] The SEC, of course, devotes enormous resources to the detection and punishment of insider trading. There are, however, more subtle forms of self-interested behavior. A committee member could advocate for a stock's addition to or subtraction from an index because of a personal investment. The index provider or its affiliates could engage in activities that generate an incentive to add or subtract companies from an index. These would be far less visible than insider trading but could adversely affect fund returns.

The fact that indices are used for multiple purposes also has the potential to create conflicting interests. The providers of the leading general indices have (at least) two groups of customers: those that seek to track the index (i.e., index funds), and those that use the index as a benchmark (often active managers). Because the preferences of these two groups will often diverge, it falls to the index provider to choose how to balance these divergent demands.

This point is worth emphasizing. In practical terms, the providers of general indices sell the same list of securities (with the associated weights) to several different groups of customers. One group—the money managers (whether they be of registered mutual funds or otherwise) who are benchmarking against the index— are generally compensated based on their ability to exceed the performance of the index.[43] At the margin then, they are better off when the returns of the index are low in absolute terms. The second group—the index fund managers—at the margin, are better off when the

[42] *See* United States v. Yang, Complaint and Affidavit in Support of Application for Arrest Warrant (E.D.N.Y. 2020); Patricia Hurtado, S&P Index Manager Charged with $900,000 Insider-Trading Scheme, BLOOMBERG, (Sept. 21, 2020), https://www.bloomberg.com/news/articles/2020-09-21/s-p-index-manager-charged-with-900-000-insider-trading-scheme.

[43] Some active managers are expressly compensated based on performance. Even in contexts where relative performance compensation is less common, such as registered investment companies, fund complexes often collect fees on the basis of assets under management (AUM), and fund flows have been shown to follow performance relative to benchmark. *See generally* Berk A. Sensoy, *Performance Evaluation and Self-Designated Benchmark Indexes in the Mutual Fund Industry*, 92 J. FIN. ECON. 25 (2009).

returns of the index are higher.[44] A third group may market options or futures contracts on the index. This group likely has no preference over the index return but may prefer higher (or lower) volatility, which affects the value of an option. Because they sell the same portfolio to multiple constituencies, the index providers are likely striking some balance between these competing forces.

Once again, there is nothing inherently wrong with index providers marketing to different groups with divergent interests. The regulatory interest is simply in ensuring that the index provider accurately describes the way in which it exercises the discretion built into its methodology and avoids conflicted decisions. The SEC has accordingly taken an interest in index providers' public disclosures. In July 2020, the SEC informed S&P Global, the public company that owns the S&P family of indices, that its staff has recommended enforcement action based on the "absence of disclosure of a quality assurance mechanism" in an S&P volatility index.[45] The safe harbor rule that we propose in Part IV below would require disclosures about an index's methodology. It would thereby create a firmer evidentiary base for any anti-fraud enforcement by the SEC.

3. The Rise of Single Purpose Indices

While the paradigmatic index fund tracks a general index, this paradigm reflects only one piece of the index fund market. In an increasingly important part of the index fund market, the index being tracked has no established users outside of the fund that tracks it. In effect, the index exists specifically so that an index fund can track it. Index providers develop single purpose indices at the request of the prospective index fund's managers based on specifications the managers provide. This is significant because, as we will see in Part II, the regulatory system draws a line between personalized and non-personalized recommendations.

While there is no systematic information about the inner workings of the market for single purpose indices, some information can be gleaned from publicly available sources, including SEC filings. For example, some funds that rely on such an index note that the index is constructed using a "proprietary" methodology developed by the fund manager.[46] Index providers may

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[44] The fees collected by index funds are generally function of AUM, which can be increased by two means: net inflows to the fund, and higher returns. Because net fund flows are positively correlated with raw returns and higher returns also boost AUM, both of these dimensions—fund flows and organic growth—push in the same direction.

[45] *See* S&P Global Inc., Form 10-Q, at 26 (July 28, 2020), https://www.sec.gov/ix?doc=/Archives/edgar/data/64040/000006404020000144/spgi-20200630.htm.

[46] For example, the December 22, 2017, summary prospectus for the "Deep Value ETF," which tracks the "TWM Deep Value Index" notes that "[t]he Index was created in 2014 in anticipation of the commencement of operations of the Fund." Deep Value ETF, Summary Prospectus (Form N-1A) 4 (Dec. 22, 2017), https://www.sec.gov/Archives/edgar/data/1540305/000089418917006876/ess_dv-497k.htm.

create an index bearing a name associated with the fund family at the behest of the fund sponsor.[47] Still others are clearly designed to be tracked by an index fund although not expressly styled as such. These include many so-called "smart beta" or "factor" indices, which seek to capture some specific investing strategy[48] in the form of an index.

Single purpose indices further attenuate the distinction between portfolio management and index provision. These indices have no meaningful commercial purpose other than to provide the template for an index fund's portfolio selection. While the providers of general indices can argue that tracking by index funds is simply ancillary to the index's informational uses, the providers of single purpose indices cannot.

The manner in which single purpose indices are framed and marketed is instructive. The traditional index fund makes a simple claim: it doesn't engage in costly attempts to beat the market and passes on the resulting cost savings to the investor. As John Bogle of Vanguard Group put it more pithily, "Don't look for the needle in the haystack. Just buy the haystack!"[49]

The providers of single purpose indices, by contrast, sell their ability to identify particularly promising parts of the haystack. Necessarily, then, they emphasize the potential to outperform the broader market. Indeed, a number of posts on the S&P Dow Jones Indices "Indexology Blog" refer to specialized indices "outperforming" their benchmarks or "capturing outperformance."[50] By contrast, it is a contradiction in terms to refer to the S&P 500 or the Dow Jones Industrial Index as outperforming a benchmark portfolio.

Providers of single purpose indices also market their ability to tailor an index to the needs of a particular user. Solactive, which provides single purpose indices, notes that it can design indices based on a variety of criteria or

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[47] For example, the January 27, 2017 summary prospectus for the "Franklin LibertyQ U.S. Equity ETF," which tracks the "LibertyQ U.S. Large Cap Equity Index," states that the index "is a systematic, rules-based proprietary index maintained and calculated by FTSE Russell . . . based on the Russell 1000 Index *using a methodology developed with Franklin Templeton to reflect Franklin Templeton's desired investment strategy*" (emphasis added). Franklin LibertyQ U.S. Equity ETF, Summary Prospectus (Form N-1A) 4 (Jan. 27, 2017).

[48] FTSE Russell, Implementation Considerations for Factor Investing 14 (Mar. 2018), https://content.ftserussell.com/sites/default/files/research/implementation_considerations_of_factor_investing.pdf (noting that "[a] more recent offering is the introduction of smart beta or factor investing techniques into the asset allocation framework of many institutional investors. This approach aims to identify combinations of rewarded investment risk factors which may be capable of improving levels of portfolio diversification, generate incremental performance relative to traditional market-cap indexes and /or reduce risk).

[49] *See* Kent Thune, John Bogle Quotes on Mutual Funds and Index Investing, https://www.thebalance.com/john-bogle-quotes-on-mutual-funds-and-index-investing-2466511.

[50] Fei Mei Chan, *Winning by Losing Less*, S&P Dow Jones Indices Indexology Blog (Nov. 15, 2019, 4:00 PM), https://www.indexologyblog.com/2019/11/15/winning-by-losing-less; Karina Tjin, *Outperforming with Systematic Sector Bets Using the S&P 500 Sector Rotator Daily RC2 5% Index*, S&P Dow Jones Indices Indexology Blog (Nov. 13, 2019, 4:22 PM), https://www.indexologyblog.com/2019/11/13/outperforming-with-systematic-sector-bets-using-the-sp-500-sector-rotator-daily-rc2-5-index.

factors "in order to outperform" a benchmark.[51] Single purpose indices, in short, attempt to achieve the best of both worlds. They achieve the marketing advantage of being an "indexed" or "passive" strategy while allowing an investor to achieve a specific objective such as exposure to companies with specific characteristics.

These indices blur the distinction between passive management and active stock selection. The provider constructs an index with the objective of outperforming some other, typically broader, index. It then licenses the index to a fund, in effect managing the fund's portfolio in return for compensation. This may be a desirable from of portfolio management, and nothing in our analysis bears upon the merits of any particular index, or indices in general. It does, however, bear upon the manner in which these indices should be regulated under the current securities regulatory regime.

II. Investment Advisers under the Investment Advisers Act & Investment Company Act

The regulation of asset managers in the United States stems from two statutes.[52] The IAA regulates professionals who directly advise end investors, both retail and institutional.[53] The IAA's better-known cousin, the ICA (sometimes known simply as the "1940 Act"), regulates collective investment vehicles such as mutual funds and ETFs, which we will refer to generally as "funds."[54]

A. *The Definition of Investment Adviser*

Each statute contains its own definition of "investment adviser." In neither case does the definition turn on whether the person self-describes as an "active" or "passive" manager. The IAA version, contained in Section 202(a)(11), includes two categories: "any person who, for compensation, engages in the business of advising others" on securities investing, and any person who "for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities."[55]

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[51] *Index Development*, Solactive, https://www.solactive.com/what-we-do/index-development/ (last visited Feb. 5, 2020) ("Indices can be designed to offer exposure to a particular thematic field, meet certain environmental, social and governance (ESG) criteria, or employ various factors in order to outperform. Strategies can also be either delta-one or non-delta-one, considering, for example, currency-hedged indices, long/short indices, volatility target/cap indices, leveraged indices, delta-hedged indices, as well as optimization indices.").

[52] For a more detailed discussion of the structure and regulation of mutual funds, see generally William A. Birdthistle, Empire of the Fund: The Way We Save Now 30–48 (2016).

[53] Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1–18c (2018).

[54] Investment Company Act of 1940, 15 U.S.C. §§ 80a-1–64 (2018).

[55] Investment Advisers Act § 202(a)(11), 15 U.S.C. § 80b-2(a)(11) (2018).

Section 2(a)(20) of the ICA defines an "investment adviser" of an investment company as:

> *(A) any person . . . who pursuant to contract with such company regularly furnishes advice to such company with respect to [investments], or is empowered to determine what securities or other property shall be purchased or sold by such company, and*
>
> *(B) any other person who pursuant to contract with a person described in clause (A) regularly performs substantially all of the duties undertaken by such person described in clause (A)*[56]

In principle, an investment adviser to an investment company could fail to meet the IAA investment adviser definition.[57] In practice, however, investment advisers under the ICA are a subset of advisers under the IAA—the subset that advises registered investment companies. The ICA singles out those advisers for additional regulatory requirements discussed in subpart d. below. An investment adviser registered under the IAA, however, may provide certain limited advisory services, such as securities research, to an investment company without meeting the ICA's investment adviser definition and therefore without incurring these additional requirements.

The SEC regulates sub-advisers similarly, but not identically, to primary advisers. Subsection (B) of the ICA definition covers a person whose contract is with the primary adviser, not the fund. It is limited, however, to a person who performs "substantially all" of the primary adviser's duties. In the typical manager-of-managers structure, sub-advisers engage only in portfolio selection while the primary adviser handles other administrative aspects of managing the fund.[58]

The SEC nevertheless considers a sub-adviser to meet subsection (B) of the investment adviser definition.[59] Implicitly, then, the SEC interprets the phrase "substantially all of the duties" to refer to *portfolio selection* rather than administrative duties. As a matter of statutory interpretation, this makes perfect sense: administrative services, while important, are not the reason that someone is treated as an investment adviser. If Fidelity provided only accounting services and not investment selection to mutual funds, it would not be an investment adviser.[60]

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[56] Investment Company Act § 2(a)(20), 15 U.S.C. § 80a-2(a)(20) (2018).

[57] For example, the IAA definition is limited to those who advise on investments in securities, whereas the ICA definition is not so limited. Should an investment company use, for example, currency forwards and derivatives for hedging purposes and hire a separate manager to oversee that portion of the portfolio, that manager could be an adviser under the ICA but not the IAA.

[58] *See* Gregory C. Davis et al., Mutual Fund Use of Sub-Advisers 42-3 to 42-4 (2013), https://www.ropesgray.com/~/media/Files/articles/2013/11/PLI-Nov2013.ashx (describing division of responsibilities between primary adviser and sub-advisers).

[59] *Id.*

[60] We thank John Morley for suggesting this example.

B. *The Publisher's Exclusions*

Both statutes contain exclusions from their broad definitions of investment adviser. Of interest for our purposes are exclusions for publishers. Without these exclusions, the *Wall Street Journal*, for example, would fall within the investment adviser definition given that its articles do not merely compile data, but provide evaluative commentary and judgments about companies and markets. To consider the newspaper an investment adviser would be inconsistent with the statutory purpose and raise an obvious First Amendment concern.

The IAA accordingly excludes the publisher of any "bona fide" publication "of general and regular circulation."[61] The ICA excludes the provision of advice through "uniform publications distributed to subscribers thereto."[62] The SEC has not adopted rules or issued any interpretive releases specifying the coverage of the publisher's exclusions.

There is, however, an important Supreme Court opinion interpreting the IAA exclusion. In *Lowe v. SEC*, the SEC sought to enjoin publication of a market letter by a former investment adviser whose registration had been revoked for misconduct.[63] The petitioner claimed to qualify for the publisher's exclusion and separately argued that to enjoin publication would violate the First Amendment.[64] Drawing on Second Circuit precedent, the SEC argued that the publisher's exclusion applied to general-interest publications but not to a market letter that is "primarily a vehicle for distributing investment advice."[65]

Applying a presumption that Congress wished to avoid constitutional infirmities, the Court concluded that the IAA was concerned principally with those who offer personalized advice. By contrast, the "mere fact that a publication contains advice and comment about specific securities does not give it the personalized character that identifies a professional investment adviser."[66] The Court went on to conclude that absent evidence that the publication at issue recommended securities in which the publishers had an undisclosed interest, contained false or misleading statements, or served as a vehicle for personalized advice, it was a "bona fide" publication for purposes of the statutory text.[67] It finally concluded that the publication was of "regular" circulation despite its sporadic appearance because publication was not timed to "specific market activity."[68]

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[61] Investment Advisers Act § 202(a)(11)(D), 15 U.S.C. § 80b-2(a)(11)(D) (2018).
[62] Investment Company Act § 2(a)(20)(i), 15 U.S.C. § 80a-2(a)(20)(i) (2018).
[63] Lowe v. SEC, 472 U.S. 181 (1985).
[64] *Id.* at 186–87.
[65] *Id.* at 207 (footnote omitted).
[66] *Id.* at 208.
[67] *Id.* at 209.
[68] *Id.*

The Court's decision both narrowed the definition of investment advice and broadened the publisher's exclusion. In response, the SEC declared that determining whether a given publication qualified for the publisher's exclusion was so "fact-specific" that it would no longer provide no-action letters on the question.[69]

Subsequent cases in the lower courts have seized upon *Lowe*'s suggestion that only a publication providing unconflicted and non-misleading advice could be "bona fide." In *SEC v. Park*, the defendant operated a web site containing a publicly available area and a members-only area that gave paid subscribers access to the defendant's stock picks and a chat site.[70] The defendant moved to dismiss on the grounds that it met the IAA's publisher's exclusion and was, therefore, not an unregistered investment adviser.

The court denied the motion to dismiss, noting that the SEC had alleged both that some of the information underlying the defendant's recommendations was misleading and that the defendant had recommended stocks in which it or affiliated entities had an undisclosed financial interest.[71] The allegations were sufficient, the court found, potentially to destroy the "bona fide" nature of the publication.[72] The SEC also alleged that the site provided personalized advice, making the exclusion unavailable.

There is no equivalent judicial application of the ICA's publisher's exclusion. The leading treatise on the law of investment management contends that a publication is "uniform" when it is not individually tailored to particular investment company clients.[73] That position makes the "uniform" concept analogous to the line between personalized and non-personalized advice in the IAA context. The treatise also contends that "distributed to subscribers" implies public distribution. This presumably means that subscriptions are broadly available, not that they are given away for free. While entirely sensible, these interpretations of the statutory language do not originate in judicial or SEC decisions.

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[69] *See* Charles L. Simpson, 1992 SEC No-Act. LEXIS 802.

[70] *See* Sec. & Exch. Comm'n v. Park, 99 F. Supp.2d 889 (N.D. Ill. 2000).

[71] *Id.* at 895 ("Defendants persuaded subscribers . . . using . . . misleading performance results . . . . Moreover, the SEC maintains that in certain instances, Defendants . . . promot[ed] stocks in which they either had an interest or for which they were being paid to recommend without revealing their interests.").

[72] *Id.* at 895–96; *see also* Murphy v. Reynolds, 2011 Tex. App. LEXIS 7818, at 10 (2011) (holding that "bona fide" publication for purposes of Texas statute with identical relevant language turns on whether publications contain false or misleading information or "tout" securities). *But see* Sec. & Exch. Comm'n v. Terry's Tips, 409 F. Supp.2d 526, 531–32 (D. Vt. 2006) (explaining that the Court suggested in *Lowe* that undisclosed financial interest may not destroy the publisher's exclusion if the advice is not personalized, but concluded that defendants were otherwise engaged in investment advisory activities).

[73] *See* Tamar Frankel & Arthur B. Laby, The Regulation of Money Managers: Mutual Funds and Advisers 3–95 (3d ed. 2016).

C. The Consequences of Being an Investment Adviser

As enacted, the IAA provided for little more than a census of professional investment advisers coupled with a general antifraud rule.[74] Over time, the SEC increased the disclosure requirements for, and oversight of, investment advisers and Congress added a limitation on performance-based fees.[75] A person that meets the investment adviser definition must, with certain exceptions, register with the SEC, avoid performance-based fees, and act as a fiduciary for its clients.

1. Registration

Section 203(a) of the IAA makes it unlawful for an investment adviser to use jurisdictional means to carry out its business unless registered.[76] The registration requirement is subject to various exceptions, but none apply to an adviser to a registered investment company. In particular, Section 203A divides principal regulatory jurisdiction between the SEC and state securities regulators based on the amount of assets under management, but requires registration with the SEC of all investment advisers acting as advisers to registered investment companies.[77]

An adviser subject to registration files and annually updates Form ADV.[78] The form calls for detailed information about the adviser's ownership and governance structure, employees, clients and client types, business practices, and fees, among other things. The adviser must also prepare a client brochure containing a plain-English version of many of these disclosures and provide it to advisory clients and prospective clients. The SEC has recently required investment advisers to provide clients a "relationship summary" describing the "nature of their relationship" with the adviser.[79]

Registration subjects the adviser to detailed recordkeeping requirements.[80] In addition, the SEC's Division of Examinations conducts compliance examinations of investment advisers and investment companies.[81]

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[74] *See* Joel Seligman, The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance 222 fn. (3rd ed. 2003) ("[Statute provided] little more than a pro forma registration requirement . . . and antifraud provisions.").

[75] *See* 15 U.S.C. § 80b-5(a)(1) (2018) (Registered investment adviser may not enter into an advisory contract that "provides for compensation to the investment adviser on the basis of a share of capital gains . . . or capital appreciation.").

[76] 15 U.S.C. § 80b-3(a); *see also* 17 C.F.R. § 275.203-1. The statute gives the SEC the authority to enforce its provisions through injunctions and civil penalties. *See* 15 U.S.C. § 80b-9 (2018). Willful violation is a criminal offense. 15 U.S.C. § 80b-17.

[77] 15 U.S.C. § 80b-3a(a)(1)(B).

[78] *Form ADV Instruction Page*, Sec. & Exch Comm'n, https://www.sec.gov/files/formadv.pdf. Certain events trigger an updating requirement between the annual updates. *Id.*

[79] Form CRS Relationship Summary; Amendments to Form ADV, 84 Fed. Reg. 33,492, 33,551 (July 12, 2019).

[80] *See* 15 U.S.C. § 80b-4 (2018); 17 C.F.R. § 275.204-2 (2019).

[81] *See* 15 U.S.C. § 80b-4(b)(6) (2018); *About the Division of Examinations*, Sec. & Exch Comm'n, https://www.sec.gov/exams/about (modified Dec. 17, 2020).

2. Fiduciary Duty to Clients

Although the IAA doesn't explicitly state that a registered investment adviser is a fiduciary for its clients, courts both before and after its enactment recognized that managing money for a client is a classic fiduciary relationship.[82] As in other fiduciary settings, the precise duties owed depend on the specific services the adviser provides the client. In general, however, fiduciaries are expected to disclose interests that may conflict with the client's and to provide the relevant services with reasonable professional skill and diligence.

In *SEC v. Capital Gains Research Bureau*, the Supreme Court concluded that a breach of an adviser's fiduciary duty of loyalty constituted a violation of the IAA's general antifraud provision, Section 206.[83] That provision makes it illegal, among other things, for an investment adviser to defraud a client or engage in an act "which operates as a fraud or deceit upon any client or prospective client."

The latter phrase is critical to the result. The Supreme Court has concluded that a breach of fiduciary duty is not a "manipulative or deceptive device" for purposes of Section 10(b) of the Exchange Act.[84] The Court has also concluded, however, that the phrase "operates as a fraud or deceit" focuses on the consequences to the victim rather than the level of culpability of the violator and accordingly encompasses a wider range of misconduct than common-law fraud.[85]

A breach of an investment adviser's fiduciary duty accordingly violates Section 206(2), which the SEC may enforce through an action for an injunction or civil penalty or an administrative cease and desist order.[86] Unlike Exchange Act Rule 10b-5, however, the Supreme Court has declined to find a private right of action for damages under Section 206(2).[87] The IAA imposes further obligations on investment advisers, including full disclosure of

[82] *See* Frankel & Laby, *supra* note 73, at 13-3 n.2; *see also* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. 33,669, 33,669 (July 12, 2019) ("Under federal law, an investment adviser is a fiduciary.").

[83] Sec. & Exch. Comm'n v. Cap. Gains Res. Bureau, 375 U.S. 180, 194–95 (1963).

[84] Santa Fe Indus. v. Green, 430 U.S. 462, 474–77 (1977).

[85] *See* Aaron v. SEC, 446 U.S. 680, 694, 697 (1980) (contrasting language of Exchange Act § 10(b) and Securities Act § 17(a)); *see also* Commod. Futures Trading Comm'n v. Savage, 611 F.2d 270, 281–82 (9th Cir. 1979) (construing similar language in Section 4o of the Commodity Exchange Act, 7 U.S.C. § 6o (2018)).

[86] *See* 15 U.S.C. §§ 80b-3(k) (cease-and-desist order), 80b-9(d) (injunctive action), 80b-9(e) (civil monetary penalty).

[87] Transamerica Mortg. Advisers v. Lewis, 444 U.S. 11, 19–24 (1979). The same case found that Section 215 of the IAA recognizes a private right of action for injunctive or rescissory relief from a void advisory contract. *Id.* at 18–19.

all material facts,[88] rules preventing the misuse of nonpublic information,[89] and a requirement that the adviser have a code of ethics.[90]

3. Limitations on Performance-Based Fees

Section 205(a) of the IAA generally bars an investment adviser from receiving performance-based compensation from retail clients.[91] The provision does not apply, however, to an advisory contract between an adviser and a registered investment company that provides for symmetrical increases and decreases in compensation depending on the relative performance of the fund and "an appropriate index of securities prices" or similar benchmark.[92] SEC rules permit investment advisers to contract for performance-based compensation with certain institutional and high-net worth clients.[93]

4. Additional Duties Under the ICA

If the advisory client is an investment company registered under the ICA, the adviser is subject to additional requirements and limitations. These reflect the ICA's general attempt to limit the ways in which the sponsors of investment companies may earn hidden profits for themselves or their affiliates.[94]

The ICA generally limits transactions between an investment company and any "affiliated person," defined to include "any investment adviser thereof."[95] Subject to various exceptions and exemptions, prohibited transactions include loans, purchases or sales of assets, or the receipt of commissions or similar compensation in connection with purchases and sales of assets.[96]

The ICA also contains anti-pyramiding provisions that, among other things, make it illegal for any group of investment companies with the same adviser to acquire more than ten percent of the voting stock of any registered

[88] *See generally* Sec. & Exch. Comm'n v. Cap. Gains Res. Bureau, 375 U.S. 180 (1963); In the Matter of Arleen W. Hughes, Exchange Act Release No. 4048 (Feb. 18, 1948).

[89] 15 U.S.C. § 80b–4a.

[90] Investment Adviser Codes of Ethics, 17 C.F.R. § 275.204A-1. This includes reporting of personal securities transactions by "access persons." 17 C.F.R. § 275.204A-1(b) (where "access persons" are defined in 17 C.F.R. § 275.204A-1(e)(1)).

[91] 15 U.S.C. § 80b-5(a) (2018).

[92] 15 U.S.C. § 80b-5(b)(2)(A); 17 C.F.R. §§ 275.205-1, 275.205-2.

[93] 17 C.F.R. § 275.205-3 (permitting performance-based compensation in contracts with a "qualified client").

[94] *See* Wagner-Lea Act: Hearing on S. 3580 Before a Subcommittee of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess. 37 (1940) (statement of SEC Commissioner Robert Healy) ("[T]oo often investment trusts and investment companies were organized and operated as adjuncts to the business of the sponsors and insiders to advance their personal interest at the expense of and to the detriment of their stockholders.").

[95] 15 U.S.C. § 80a-2(a)(3) (2018).

[96] 15 U.S.C. § 80a-17(a).

closed-end investment company.[97] It further limits a registered investment company's ability to invest in securities of any company that acts as an investment adviser under either the IAA or the ICA.[98]

An investment adviser to an investment company must provide advice pursuant to a written contract on terms approved by the fund's shareholders and subject to termination at any time by the board or shareholders.[99] An adviser may also bear responsibility for actions that violate the investment company's stated investment policies.[100] While the ICA imposes a direct duty on the investment company itself to avoid violations of certain investment policies, the SEC takes the position that an investment adviser may be sanctioned for aiding and abetting such violations.[101]

The ICA provides that the fiduciary duties of a fund's investment adviser include the avoidance of excessive compensation.[102] A fund shareholder may bring an action against the fund's adviser on the fund's behalf to recover excessive fees.

These operational and conflict of interest provisions could have potentially far-reaching consequences for sub-advisers. In many instances, the registered investment company is a trust with multiple series, each constituting a distinct mutual fund and possibly with distinct sub-advisers. The registered investment company could therefore have dozens of "investment advisers" notwithstanding that many of them would manage only a single fund or a single portion of a fund.

In recognition of that fact, the SEC's rules limit the duties of a sub-adviser outside the scope of the particular fund or portfolio it oversees. For example, for purposes of Section 17(a) of the ICA, which prohibits transactions between a fund and its affiliates, including investment advisers, the SEC treats a sub-adviser as if it were not an affiliate of the funds or portfolios it does not advise.[103]

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[97] 15 U.S.C. § 80a-12(d)(1)(C).

[98] 15 U.S.C. § 80a-12(d)(3).

[99] 15 U.S.C. § 80a-15(a).

[100] *See* 15 U.S.C. § 80a-13(a) (barring changes in certain investment policies without shareholder authorization).

[101] *See generally* Frankel & Laby, *supra* note 73, at 21–185.

[102] 15 U.S.C. § 80a-35(b) (2018). For a discussion of the operation of this provision, see Quinn Curtis & John Morley, *The Flawed Mechanics of Mutual Fund Fee Litigation,* 32 YALE J. ON REG. 7–9 (2015).

[103] *See* 17 C.F.R. § 270.17a-10 (2019). The adopting release for Rule 17a-10 notes that the rule permits a sub-adviser "to enter into transactions with funds the subadviser does not advise" and "to enter into transactions and arrangements with funds the subadviser does advise, but only with respect to discrete portions of the subadvised fund for which the subadviser does not provide investment advice." *See* Transactions of Investment Companies With Portfolio and Subadviser Affiliates.

III. Do Index Providers Satisfy the Definition of Investment Adviser under the IAA & the ICA?

In this Part, we combine the analyses in Parts I and II and ask whether persons who provide indices to index funds satisfy the definition of "investment adviser" under either the IAA or the ICA. We conclude that while the providers of single purpose indices almost certainly constitute investment advisers under the IAA, the providers of general indices probably do not. We then turn to the ICA. Here, the analysis is more ambiguous, both because of the language of the statute and the relatively sparse case law and regulatory guidance on the question. Our policy proposals in Part IV are then crafted in light of the analysis in this part.

A. *Do Index Providers Satisfy the Definition of Investment Adviser Under the IAA?*

We first consider whether index providers satisfy the definition of an "investment adviser" contained in Section 202 of the IAA.[104] We proceed in two steps, first asking whether index providers constitute investment advisers without reference to the exclusions. Because, as we shall see, the publisher's exclusion is the most relevant to our analysis, we then turn to whether index providers qualify for this exclusion.

The definition has generally been interpreted to contain three prongs, all of which must be satisfied for a person or entity to qualify as an investment adviser: that the person or entity (a) is engaged in the business of (b) providing advice to others or issuing reports or analyses regarding securities (c) for compensation.[105] Because the second prong is the core of the definition, and because (a) and (c) are more easily discussed in relation to (b), we begin by considering the second prong.

1. Providing a Stock Market Index to an Index Fund Satisfies the SEC's Interpretation of Providing Advice to Others or Issuing Reports or Analyses Regarding Securities

For the purpose of this prong, the question is whether providing a securities index to an index fund constitutes "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 "issu[ing] or promulgat[ing] analyses or reports concerning securities." As we discuss

[104] 15 U.S.C § 80b-2(a)(11).

[105] Proponents of this view include the SEC's Division of Investment Management. *See* Staff of the Investment Adviser Regulation Office, Division of Investment Management, U.S. Securities and Exchange Commission, Regulation of Investment Advisers by the U.S. Securities and Exchange Commission (Mar. 2013) [hereinafter Regulation of Investment Advisers].

in more detail below, the SEC has repeatedly taken a broad view of what constitutes both advice and reports and analyses concerning securities.

While these are, in principle, two separate sets of activities (providing advice and issuing reports), it can be hard to draw a sharp distinction between the two. It is therefore not surprising that they are often considered in tandem. In the remainder of this subpart, we argue that index providers are straightforwardly engaged in the first set of activities. We consider the second as well because the SEC has recognized certain communications not to constitute "analyses or reports." The SEC or a court might decide that the same exceptions apply to the terms "publications or writings." We argue, however, that index providers fail to meet these exceptions.

a. Knowingly providing a list that a fund will treat as a portfolio allocation is "advising . . . as to the advisability" of trading in securities.

The substance of the relationship between an index provider and an index fund is straightforward. The latter acquires, by license, a list of securities and corresponding weights. Both parties understand that the fund will seek to replicate the return on the index. This is implicit in the fact that the fund also acquires the right to use the index's brand alongside the fund sponsor's brand, as in "Vanguard S&P 500 ETF." The index provider does not, however, execute trades for the fund or provide specific recommendations, analysis, or other commentary regarding the securities on the list.

The index provider does, however, represent that the list captures whatever market, market segment, or for lack of a better term, strategy, that the index is supposed to capture. As such, it communicates the "advisability of investing in" the securities on the list to a fund that desires to mimic the related return.

While the provider does not suggest in so many words that the fund purchase the securities on the list, both parties enter into the licensing transaction with the understanding that the fund will do so. An explicit statement "buy the stocks on this list" cannot be a prerequisite to the statute's applicability. If so, any securities analyst could send its clients a bare list of stocks and weights, unaccompanied by a formal recommendation, and argue that it is not an "adviser." Compiling a list of securities with the intent or understanding that an investor will use it to assemble a portfolio must constitute "advice" for the regulatory system to make any sense.

The SEC's interpretation of the definition supports this view. It has taken a clear position that implicit advice is sufficient to trigger regulation under the IAA.[106] The SEC has also been clear in its position that providing something that, in practice, could operate as a portfolio selection tool can

[106] *See, e.g.*, Christiana J. Green, SEC No-Action Letter, 1989 SEC No-Act. LEXIS 723 *1 to *2 (May 30, 1989).

constitute "advice" for the purposes of the IAA. For example, the staff of the SEC's Division of Investment Management (Division) has opined that "providing a selective list of securities is advice about securities even if no advice is provided as to any one security."[107] An index is, unambiguously, a selective list of securities. It is advice, as would be a selective list without the title "index" written on the top.

b. Providing an index to an index fund does not fall into the long-standing safe harbor that the SEC has provided in its no action letters

In addition to providing advice as to the advisability of securities investments, promulgating "analyses or reports" concerning securities makes one an investment adviser. The plain meaning of the term "analyses or reports" includes an index together with the provider's criteria and methodology for constructing the index. Through the no-action letter process, however, the SEC's staff has taken the position that certain compilations of information about securities do not constitute analyses or reports for purposes of the definition. Given the fine line between "publications or writings" and "analyses or reports," it is possible that the SEC or a court would conclude that the same exceptions apply to both sets of activities. We accordingly consider those exceptions here.

The staff's views are set out in a series of no action letters beginning in 1982. They apply a three-pronged test: information related to securities does not meet the statutory definition when (1) "the information provided is readily available in its raw state," (2) "the categories of information presented are not highly selective," and (3) "the information provided is not organized or presented in a manner which suggests the purchase, holding, or sale of any security or securities."[108] The SEC has referred to this three-pronged test repeatedly in subsequent no action letters.[109] Indeed, the SEC considers its "views regarding the circumstances in which the presentation of securities information constitutes an analysis or report concerning securities for purposes of section 202(a)(11)" of the IAA sufficiently well established that it "will no longer respond to such requests for interpretative or no-action letters in this area unless they present novel or unusual issues."[110]

The provision of an index to an index fund would not satisfy any of the three prongs of the SEC's test, let alone all three of them. The first prong,

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[107] Regulation of Investment Advisers, *supra* note 105, at 3.

[108] Michael R. Kaus, SEC No-Action Letter, 1982 SEC No-Act. LEXIS 1905 *2 (Feb. 8, 1982).

[109] *See, e.g.*, Butcher & Singer SEC No-Action Letter, 1987 SEC No-Act. LEXIS 1477 (Jan. 2, 1987); Media General Financial Services Inc., SEC No-Action Letter (Jul. 20, 1992); EJV Partners, L.P., SEC No-Action Letter, 1992 SEC No-Act. LEXIS 1130 (Dec. 7, 1992); Datastream International, SEC No-Action Letter (Mar. 15, 1993); RDM Infodustries, Inc., SEC No-Action Letter (Mar. 25, 1996).

[110] RDM Infodustries, SEC No-Action Letter, *supra* note 109, at 2.

that "the information provided is readily available in its raw state," allows for the publication of reports that contain no editorial or other commentary, implicitly or explicitly. For example, the SEC has issued no action letters on this basis to entities that provided a database of bond market information,[111] data on public companies, bonds, and investment companies,[112] a comprehensive database of over 700 million data items consisting of global economic and financial information, including information on tens of thousands of stocks and bonds,[113] and the publisher of a report with information about how money market funds work, including a list of the names and basic information about 62 different money market funds, all of which was available in its raw state.[114] In contrast, the SEC declined to provide no action relief to Butcher & Singer for a service that, using publicly available information and data from an individual's portfolio, calculated the "estimated annual income and the market value of each security as a percentage of the total value of the portfolio" because these percentages did not constitute information that was readily available in its raw state.[115] Even when the SEC granted no action relief to an entity that did not strictly meet the first prong, the information that was not in its raw state was a matrix pricing service consisting of mathematical modeling tools.[116]

In contrast to these services, compiling an index, as we have described above, is an inherently discretionary exercise. The index provider decides which market or market segment to track and which securities and associated weights will best do so. Even if the SEC uses the term "readily available in its raw state" to mean information that an investor could replicate from a bare description, very few indices, and none of the best-known ones, would qualify.

The second prong, that "the categories of information presented are not highly selective," is also unlikely to be met. It is hard to imagine any notion of "highly selective" categories that does not capture information that consists solely of a list with two columns—the constituents and the associated weight. In contrast, when the SEC has granted no action relief, it has generally done so in the context of information providers that provide a broad range of information for research purposes.[117]

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[111] EJV Partners, L.P., SEC No-Action Letter, *supra* note 109.

[112] Media General Financial Services Inc., SEC No-Action Letter, *supra* note 109.

[113] Datastream International, SEC No-Action Letter, *supra* note 109.

[114] Michael R. Kaus, SEC No-Action Letter, *supra* note 108. The other basic information included fund contact information, "minimum initial investment, subsequent investment and amount that may be redeemed by check writing, and whether a fund invests only in Government securities or charges any amount for redemption by check writing." *Id.* Note that at this point in time, money market funds were much less common than they are today.

[115] Butcher & Singer, SEC No-Action Letter, *supra* note 109.

[116] EJV Partners, L.P., SEC No-Action Letter, *supra* note 109, at 6–8.

[117] *See* discussion *supra* notes 110–14 and accompanying text.

The final prong, that the "the information is not organized or presented in a manner suggesting the purchase, holding, or sale of securities,"[118] is perhaps the one it most straightforwardly fails to meet. Given that the index provider knows that the index fund's purpose in acquiring the list is precisely to design its portfolio so as to match that of the index, the notion that the index provided to an index fund does not "suggest" the purchase or holding of the securities on the index is simply not credible. Entities proposing be far less direct in any such "suggestion" have, in the past, failed to secure no action relief. For example, in denying no action relief to Butcher & Singer, the SEC's staff noted that the purpose of providing the specific categories of lightly processed information and organizing it in the proposed manner "is to provide the customer *with a basis for evaluating* whether to hold or sell existing, or to purchase different, securities for [its] portfolio."[119] Given that the purpose of an index fund is to track the underlying index, whether or not a security is in the index, and, conditional on inclusion, its weight, is unambiguously an important basis for evaluating whether to hold, purchase, or sell a security.

2. Index Providers are Engaged in these Activities as a Business

Having established that index providers satisfy the advice or reports about securities element of the definition of an investment adviser, we now ask whether they are engaged in these activities as a business.[120] This element is easily satisfied in this context.

First, the SEC has consistently taken the position that the business need not be the sole, or even the principal, business of the provider in question.[121] Rather, the requirement is satisfied as long as the activity occurs "with some regularity."[122] Abstracting away from the SEC's interpretation and focusing on the statutory text, it is clear that this requirement is met. To see this, we can take the two parts of the activity element separately. Under the first (in which providing an index to the fund that tracks it constitutes "advising"), the question reduces to whether or not the index provider "engages in the business" of providing this list. Under the second part of the activity element (in which the index is an "analysis or report concerning securities"), the question reduces to whether or not the index provider provides the index "as

[118] Media General Financial Services Inc., SEC No-Action Letter, *supra* note 109, at 2.

[119] Butcher & Singer, SEC No-Action Letter, *supra* note 109, at 3 (emphasis added).

[120] While the "business" element of the IAA definition is phrased differently for the provision of advice ("engaged in the business" of) compared to the issuance of reports (as "part of a regular business"), the SEC has taken the position that they should be interpreted in the same manner. Applicability of Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as Component of Other Financial Services, Investment Advisers Act Release No. 1092 (Oct. 8, 1987) at 8 [hereinafter IA-1092].

[121] *Id.*

[122] *Id.*

part of a regular business." In either case, the answer is clearly yes. Index providers provide this information to their index fund clients on a regular basis—indeed, their clients rely on them to do so. Without regular access to the list, the fund would not be able to pursue its objective of matching that list.

While providing this list to index funds is generally not the index provider's only, or even necessarily primary, line of business, the statute does not require this. Instead, it simply required that it be *a* business of the provider, and, at most, that it be a *regular* business. While it is possible that there exist some index providers for which this is not true, for example, providers that provide their indices only occasionally, or do so in a manner that otherwise does not constitute a business, this cannot be said for those who provide it to index funds for the purpose of tracking. For example, S&P Dow Jones Indices, LLP, the entity that provides the S&P family of indices, as well as a wide array of custom and other indices, specifically lists among its services "index licensing," including their use for "indexed funds."[123] In the same vein, FTSE Russell, another major index provider, includes "passive managers and ETF sponsors" among the categories of clients in its marketing materials, specifically describing its indices as providing the "basis of next-generation index funds and ETFs."[124] MSCI uses slightly different language, but on its "Index Solutions" page, it also prominently states that it "license[s] [its] indexes for exchange traded funds and exchange-listed futures and options."[125] None of this is meant to single out any particular index provider. Rather, it is representative of the self-evident fact that providing indices to index funds is part of the business in which index providers engage.[126]

3. Index Providers are Engaged in these Activities for Compensation

Finally, we turn to the third element of the definition, that the advice, analysis, or reports be provided "for compensation." In this context, this reduces to the question of whether index providers are compensated for the provision of indices to index funds. Here again, the answer is straightforwardly yes. While there is no systematic publicly available information about the amounts index funds, directly or indirectly through affiliates, pay licensing fees to index providers. The fact that this licensing fee may be part

[123] *Data & Index Licensing*, S&P Dow Jones Indices (last visited Feb. 21, 2021), https://www.spglobal.com/spdji/en/about-us/data-index-licensing.

[124] Guide to products and services, FTSE Russell (2019), https://content.ftserussell.com/sites/default/files/support_document/FTSE%20Russell%20Product%20Guide%20Oct%202019%20Single.pdf.

[125] *Index solutions*, MSCI (last visited Apr. 21, 2020), https://www.msci.com/index-solutions.

[126] Naturally, this observation does not extend to index providers who do not license indices to index funds.

of a larger bundle is irrelevant for this analysis. The statute explicitly uses the general term "compensation," and the SEC has taken the position that the "compensation element is satisfied by the receipt of any economic benefit."[127] Moreover, the fact that index funds may be paying for a bundle of services with the same licensing fee is immaterial: the SEC's position is that "a person pricing a variety of services to a client, including investment advisory services, for which the person receives any economic benefit, for example, by receipt of a single fee . . . would be performing such advisory services 'for compensation' within the meaning of" the statute.[128] For the purposes of the compensation element, this example captures the core of the relationship between an index provider and index fund.

4. The Publisher's Exclusion

The final step in the analysis is to determine whether any of the statutory exclusions from the definition of an investment adviser apply to index providers. There are seven such exclusions,[129] one of which might potentially apply:[130] the so-called publisher's exclusion, which provides that the definition does not include "the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation."[131] As discussed in Part II.B., the leading Supreme Court decision on the question is *Lowe v. SEC*,[132] in which the Court considered whether three corporations that published investment newsletters were "investment advisers" for the purposes of the IAA.[133] After a detailed analysis of the purpose and legislative history of the statute, the Court held that:

> *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 be-*

[127] IA-1092, *supra* note 120, at 9–10.

[128] *Id.* at 10.

[129] The remaining six are available to (A) banks and bank holding companies, (B) lawyers, accountants, engineers and teachers, (C) brokers and dealers, (E) persons providing advice relating only to certain government or exempt securities, (F) a narrow exclusion for nationally recognized statistical rating organizations, and (G) family offices. 15 U.S.C. §§ 80b-2(a)(11)(A)–(G).

[130] There is also an eighth exclusion, which excepts "such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order." 15 USC § 80b-2(a)(11)(H). Notwithstanding the fact that it has never taken the position that index providers are investment advisers under the IAA, it also has not released any rules, regulations or orders designating them one way or the other.

[131] 15 U.S.C. § 80b-2(a)(11)(D).

[132] Lowe v. SEC, 472 U.S. 181 (1985).

[133] *Id.* at 184.

> *lieve the publications are, at least presumptively, within the exclusion and thus not subject to registration under the Act.*[134]

In short, the analysis depends on the nature of the relationship between the provider of the information and its client(s). This includes both the specific features of the relationship and the extent to which the information is provided on an individualized basis.[135] Lower courts have extensively applied the Court's analysis in *Lowe* in the intervening years. While none of the contexts are entirely analogous to the relationship between index providers and index funds, the analysis in *U.S. v. Park*,[136] discussed in Part II.B, is nevertheless instructive. In that case, the "advice" was provided in the form of a website which contained a restricted portion that was available to the general public, as well as a more expansive members-only portion that was available for a fee.[137] Through this, subscribers were able to access the defendant's "tips," as well as participate in a chat room and receive emails from Park in advance of the information being made publicly available. The SEC filed a complaint against Park, for, among other things, violations of the IAA.[138]

In denying Park's motion to dismiss the claims, the Northern District of Illinois took up Park's argument that he fell within the publisher's exclusion. The court concluded Park had engaged in conduct constituting "advice that may be viewed as personalized for the purposes of the Advisers Act." This included sending emails directly to individual accounts and answering individual questions posited by clients, even if the responses were not necessarily personalized.[139] The court therefore found that the SEC had alleged the existence of sufficient facts to establish that the defendant did not fall within the publisher's exclusion.[140]

In sum, the extent to which the publisher's exclusion applies to index providers providing indices to the index funds that track them turns on two related but distinct questions: whether the advice is personalized, or whether there is a "one-on-one" relationship between the index provider and the fund. In general, the answers depend on the type of index. Whereas single purpose indices almost certainly fall outside the publisher's exclusion, general indices likely do not. We discuss each in turn. Then we turn to intermediate cases—indices that are not necessarily single purpose, but are created and maintained with substantial consultation with the funds that track them.

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[134] Id. at 210.

[135] *Id.* at 208 (noting that "petitioners' publications do not fit within the central purpose of the Act because they do not offer individualized advice attuned to any specific portfolio or to any client's particular needs. On the contrary, they circulate for sale to the public at large in a free, open market — a public forum in which typically anyone may express his views").

[136] *Park*, 99 F. Supp. 2d at 889.

[137] *Id.* at 891–92.

[138] *Id.* at 892.

[139] *Id.* at 895–96.

[140] *Id.* at 895.

a. Single Purpose Indices

Single purpose indices unambiguously fail to satisfy the requirements of the publisher's exclusion. These indices are developed precisely to meet the needs of the index fund that will track them, placing the index provider squarely within the role that is traditionally the purview of the investment adviser. The index is tailored to the needs of the fund, making the communications personalized. The fund, or one of its parent entities, negotiates "person-to-person" with the index provider about the content and pricing of the index. To the extent that the index is made more widely available, this is presumably done with the consent of, and perhaps even at the request of, the fund. The primary, and arguably the only, substantive purpose of these documents is to facilitate the creation of an index fund by acting as a blueprint for the fund's holdings. The same is likely to be true with respect to proprietary indices that are created for the purpose of "self-indexed" funds: it is hard to imagine how such an index could be viewed as providing impersonal advice.

b. General Indices

General indices are likely to qualify for the publisher's exclusion. Index providers publicize these indices and license them to multiple funds and a wide array of other market participants who use them for varied purposes. While the index provider may not charge the identical licensing fee to every client and may provide licensees more detailed information about the index than it does to the general public, much of the relevant information about such indices is ultimately made available for free online to anyone who is interested. Most notably, licensees often obtain the right to use the index's brand, which is critically important to an index fund.

The key feature of general indices is that they are provided uniformly to many different users. At any given time, the S&P 500 index, like the newsletter in *Lowe*, is the same list of securities and weights for every user, regardless of that user's purpose or its relationship with the index provider. Because of this, general indices are likely to be sufficiently "impersonal" to fit within the publisher's exclusion. While the precise details of how the list is provided, including when exactly the list is made available to each client, may vary, this variation is unlikely to be enough for the relationship to cross the line into the type of "person-to-person" relationship contemplated by *Lowe*.

The conclusion rests, however, on the assumption that the index provider's advice—the determination of the securities and associated weights—is not tainted by misleading statements or conflicting interests of the type identified in *Lowe*. We return to this point in discussing the content of a potential safe harbor rule.

c. *Intermediate Cases*

What about the great many indices that are somewhere in between these extremes? For example, take an index that is not necessarily created for the use of a single index fund, but which is, nevertheless, managed with a substantial amount of consultation with the managers of a fund that tracks it. Given the inherently fact-dependent nature of the analysis required to establish whether or not the publisher's exclusion applies, it is not possible to answer this question categorically. Ultimately, the answer will depend on the nature of the relationship between the fund and the index provider, and the extent to which the index—the advice in question—is personalized.

Notwithstanding this, certain types of relationships and behavior are more likely "personalized" than others. For example, creating (or modifying) an index at the request of a client is fairly clearly personalized advice, while having general discussions about potential changes to the index methodology, without any formal or informal understanding that the provider will make any changes to the index as a result of those discussions, is not.

5. Why Hasn't This Come Up Before?

Before proceeding to the analysis under the ICA, one might reasonably ask why, if it is so clear that at least some index providers satisfy the definition of an advisor under the IAA, has this not come up before? How, in other words, could something so significant have gone unnoticed in the eighty years since the IAA was passed? In this subpart, we offer three responses. First, there is only limited private enforcement of the IAA. Because of limited resources and other institutional features, it is not surprising that the SEC may not have emphasized the matter sua sponte. Second, while the statutes are eighty years old, the status quo in the index fund market developed gradually and came to prominence much more recently. Finally, it is not entirely true that this argument has never come up before. On the contrary, on two occasions in the past two years, SEC officials have suggested that index providers may constitute investment advisers to the mutual funds that track them. We discuss each of these arguments in turn.

a. *Because there is no meaningful private right of action, it has been up to the SEC to take this position*

A first reason this issue hasn't received much attention is that there is little scope for private enforcement of the IAA. Very few of the provisions of the statute include a private right of action, leaving enforcement largely to the SEC. As a result, enterprising plaintiffs' lawyers have had little incentive to take up the matter.

One might expect the antifraud provisions contained in Section 206 of the IAA[141] to be a ripe area for private enforcement. A similar provision in the Securities Exchange Act of 1934[142] is the vehicle through which much of the private securities litigation is brought. However, as previously mentioned,[143] the Supreme Court foreclosed a similar use of Section 206 by limiting private remedies under the IAA to voiding an investment contract.[144] While this remedy may be meaningful to the aggrieved client, it is unlikely to be attractive to enterprising plaintiffs side lawyers working on a contingency fee basis. As a result, enforcement under the IAA has been largely left to the SEC.

b. The industry has changed gradually

A second reason this issue has been largely overlooked is that, while the statutes themselves are eighty years old, the present state of the mutual fund market is quite new. As discussed in more detail in Part I, the market for index funds developed gradually over the past few decades and has really come to prominence in the last twenty years. As a result, the existing statutory infrastructure was developed for a very different market. Moreover, because the change was fairly gradual, its implications may not have been front of mind to regulators while they were happening. This is, of course, not a reason to ignore the change that occurred. Rather, it may explain why the question may have largely escaped the notice of regulators—and commentators—until now.

c. In fact, some at the SEC have drawn attention to this

While the question whether index providers are investment advisers may *largely* have escaped the notice of regulators, in the sense that the SEC has not taken a firm position on the issue, it has not gone entirely unnoticed. For example, we are aware of two instances in recent years where SEC staff have suggested that index providers who license indices to registered mutual funds may constitute investment advisers under the securities laws.

The first was a speech by Dalia Blass in March 2018, shortly after she assumed the role of Director of the Division of Investment Management. In it, Director Blass drew attention to changes in the market for index funds, including the rise of "custom" and "bespoke" indices. She then asked

[141] *See supra* note 71 and accompanying text, and notes 96–101 and accompanying text.
[142] 15 U.S.C. § 78a et seq.
[143] *See supra* note 101 and accompanying text.
[144] *Lewis*, 444 U.S. at 24 ("[W]e hold that there exists a limited private remedy under the Investment Advisers Act of 1940 to void an investment advisers contract, but that the Act confers no other private causes of action, legal or equitable.").

whether, in light of these developments, the SEC should "revisit the status of certain index providers as investment advisers."[145]

The second instance involved a new series of ETFs launched by Goldman Sachs ETF Trust (Trust) in late 2018. The Trust filed a post-effective amendment to its Securities Act and ICA registration statements to add a series of ETFs that track proprietary indices sponsored by Motif Capital Management, Inc. (Motif).[146] In response to the filing, the staff of the Division orally asked whether Motif should be considered an investment adviser to the funds, as well as why the Trust believed that the indices satisfied the publisher's exclusion under the IAA or the ICA.[147]

The bulk of the Trust's response related to the definition under the ICA,[148] as the Trust took the position that it was "not in a position to determine whether the Index Provider—an unaffiliated party—should be registered under the Investment Advisers Act."[149] The SEC did not ultimately press the issue, perhaps because Motif was already a registered investment adviser and notes in its Form ADV that it receives licensing fees from entities that use its indices.[150] While this does not render the question moot—registration is just one of the obligations of an investment adviser under the IAA—the SEC may have felt that, under the circumstances and given its limited resources, it was not worth pursuing the matter further.

B. Do Index Providers Satisfy the Definition of Investment Adviser Under the ICA?

A person that meets the "investment adviser" definition in the IAA owes fiduciary duties to its advisory clients. Acting as an investment adviser to an investment company, however, triggers additional restrictions under the ICA.[151] This Part accordingly asks whether an index provider that constitutes an investment adviser under the IAA is also an investment adviser to an index fund that licenses the index and holds itself out as tracking the index. While the two statutory definitions are similar in many respects, there are enough differences between them to warrant a separate analysis. As with the IAA analysis, we first ask whether an index provider meets the statutory

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[145] Dalia Blass, Director, U.S. Securities and Exchange Commission Division of Investment Management, Keynote Address, ICI 2018 Mutual Funds and Investment Management Conference (Mar. 19, 2018), https://www.sec.gov/news/speech/speech-blass-2018-03-19.

[146] *See* Goldman Sachs ETF Trust, Amendment to Registration Statements, (Aug. 3, 2018), https://www.sec.gov/Archives/edgar/data/1479026/000119312518237629/d597379d485apos.htm.

[147] Letter from Michelle D. Wong, Dechert LLP, to Jay Williamson, SEC (Dec. 20, 2018), at 1, 3, www.sec.gov/Archives/edgar/data/1479026/000119312518354507/filename1.htm [hereinafter Motif Letter].

[148] We discuss this part of the Trust's response in *infra* Part III.B.

[149] Motif Letter, *supra* note 147, at 5.

[150] *See* Motif Capital Management, Inc., Form ADV (Mar. 26, 2019), https://reports.adviserinfo.sec.gov/reports/ADV/277051/PDF/277051.pdf.

[151] *See supra* notes 108-12 and accompanying text.

definition without reference to its exclusions, then discuss the application of the publisher's exclusion in the ICA definition.

1. Subsection (A) of the ICA's Investment Adviser Definition

We begin with Section 2(a)(20)(A) of the ICA, which covers a person that "pursuant to contract with such company regularly furnishes advice." Having already shown that an index provider is "in the business" of providing "advice" for IAA purposes, the same logic indicates that it regularly furnishes advice for ICA purposes.

Both the terms "in the business" and "regularly" imply something more than occasional or incidental provision of a service. Index providers easily meet that standard. The motivation behind developing and maintaining an index is to earn revenue from financial firms that use the index for benchmarking or tracking purposes. This is a regular activity for an index provider.

The calculation and publication of an index that a fund will track qualifies as providing "advice . . . with respect to the desirability of investing in" specific securities or being "empowered to determine" the securities in which the fund will invest. An index fund acquires a license or sublicense for the express purpose of using an index (a list of securities and associated weights) to determine the composition of the fund's portfolio.[152] An index fund holds itself out to the public as investing in the securities that make up the index. In ordinary English, the index provider "determines" the securities in which the index fund invests.

The more challenging aspect of the definition arises from the language "pursuant to a contract." In general, the index provider does not contract directly with the registered investment company, but indirectly through the primary adviser or an affiliate of the primary adviser (we will treat the primary adviser as the licensee and ignore the specifics of the corporate structure of any given fund complex). The primary adviser then sublicenses the use of the index and associated brand name to one or more individual funds.

This is the position taken by the investment adviser to the Goldman Sachs ETF Trust, Goldman Sachs Asset Management (GSAM), in the context of the indices provided by Motif. In responding to the SEC staff's question as to why the index provider was not an investment adviser under the ICA, counsel noted that "the Index Provider has no contract with" the ETFs and is therefore not an investment adviser under Section 2(a)(20)(A).[153]

While this would seem to take the index provider out of the scope of clause (A) of the definition, the inquiry does not end there. The SEC and the

[152] *See e.g.,* MSCI Index License Agreement for Funds 1 (granting licensee the right to use specified indices as the "basis" for one or more funds and to "use and refer to" the relevant index in the fund's names) (Mar. 18, 2000), https://www.sec.gov/Archives/edgar/data/1408198/000119312511017728/dex101.htm.

[153] Motif Letter, *supra* note 147, at 3.

federal courts, in other contexts, have refused to give a strict meaning to analogous terms suggesting contractual privity. For example, Section 12(a)(1) of the Securities Act of 1933 confers a private right of action for violations of the statute's registration and prospectus delivery requirements on "any person purchasing such security from" the violator.[154] The Supreme Court, however, concluded that this language does not require that the defendant transfer title directly to the plaintiff.[155]

In the case of an index fund, the index provider and its licensee, the primary adviser, both intend that the licensee will sublicense the index to the fund. The use of a license and sublicense structure enables a fund complex to create new funds without having to go back to the index provider to amend the license agreement. It is therefore possible that the SEC or a court would take the position that the index provider and the fund are in a contractual relationship that satisfies the definition in Section 2(a)(20)(A). There are accordingly reasonable arguments for and against treating index providers as meeting that subsection.

2. Subsection (B) of the Definition

Absent the publisher's exclusion, an index provider would appear closely analogous to a sub-adviser for purposes of clause (B) of the ICA's investment adviser definition. The index provider determines the securities in which a particular mutual fund or ETF invests. That fund may be a single series of a trust that registers as an investment company. Given that the SEC considers sub-advisers to be investment advisers to the relevant fund or portfolio as defined in subsection (B), there is a reasonable argument for also treating index providers as such.

It is not clear, however, that selecting the securities for the portfolio is enough to constitute "substantially all" of the adviser's duties. In the context of the Motif funds, counsel argued that it was not, as "GSAM has management duties and obligations that go well beyond determining securities for investment."[156] It then went on to enumerate some of GSAM's management obligations in which the index provider had no role.[157] On the other hand, as noted in Part II.A. above, the SEC's treatment of sub-advisers suggests that it considers an entity that selects the fund's portfolio to perform "substantially all" of the adviser's duties even if it does not also perform administrative functions.

The resulting ambiguity has not been a problem for the SEC's position with respect to sub-advisers because the SEC has provided significant regu-

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[154] 15 U.S.C. § 77l(a) (2018).

[155] *See* Pinter v. Dahl, 486 U.S. 622, 643–45 (1988) ("A natural reading of the statutory language would include in the statutory seller status at least some persons who urged the buyer to purchase.").

[156] Motif Letter, *supra* note 147, at 3–4.

[157] *Id.* at 4.

latory relief to reduce the burden of their ICA adviser status.[158] The safe harbor approach we propose in Part IV would grant similar relief to index providers. This would provide clarity without unduly burdening index providers.

3. The Publisher's Exclusion

Even if the index provider does satisfy the general definition of an index adviser, we must determine whether it falls within the ambit of the publisher's exclusion. The language of the publisher's exclusion in the ICA is slightly different from that of the IAA. Rather than referring to "the publisher of any bona fide . . . publication of general and regular circulation,"[159] the ICA definition refers to "a person whose advice is furnished solely through uniform publications distributed to subscribers thereto."[160] An index consists of a list of securities and associated weights that the index provider licenses to various parties. Does it constitute a "uniform publication[ ] distributed to subscribers thereto"?

As noted above, the term "uniform" implies that the index is the same for all subscribers. Counsel for GSAM made precisely this argument in the context of the Motif funds. Even assuming (in the alternative) that Motif met the general definition of an investment adviser under the ICA, counsel argued that Motif would nevertheless qualify for the publisher's exclusion. It argued that the indices and their methodologies are "uniform" in that they are the same in style, form and content at any given time for all parties who access them. The Indices are "publications" in that the Index constituents and a description of the methodologies was to be made generally available through Motif's public website.

This argument implies that any mutual fund manager could qualify for the publisher's exclusion by posting the portfolio composition on a web site. This is presumably why the statute uses the term "distributed to subscribers" rather than "publicly disclosed." A subscriber, in the ordinary sense of that word, pays for access to a service. If an index provider licenses the identical list of securities and weights to multiple users for purposes of tracking or benchmarking—in short, if the index is a general index in our terminology—it may fall within the plain meaning of the ICA publisher's exclusion. If, by contrast, a single fund tracks the index, or the index is customized for particular users—a single purpose index in our terminology—it is more difficult to argue that it meets the statutory test. This is particularly true because the index provider does not "solely" post a list of securities and weights but determines them in consultation with the user.

[158] *See supra* Part II.D.4.
[159] 15 U.S.C. § 80b-2(a)(11)(D) (2018).
[160] 15 U.S.C. § 80a-2(a)(20)(i) (2018).

This interpretive difficulty is compounded by the fact that there is little case law to turn to. While there is a body of precedent interpreting and applying the publisher's exclusion under the IAA, this is not the case for the ICA analog. As a result, it is very difficult to predict how a court would rule on this question.[161]

It makes sense to interpret the ICA publisher's exclusion as turning on the same line between personalized and non-personalized advice that the Court drew in *Lowe*. While the statutory language permits that interpretation, it does not obviously compel it. We accordingly propose that the SEC use the interpretive or rulemaking process to provide a safe harbor under which, subject to certain conditions, it will not treat an index provider as an investment adviser under the ICA (and, for that matter, the IAA). This would allow it to sidestep the ambiguities and interpretive problems we have identified. In Part IV, we discuss how the SEC might formulate the rule or interpretation.

IV. Our Proposal and its Regulatory Consequences

Having concluded that single purpose index providers meet the IAA's definition of investment advisers and that general index providers do not, so long as they operate within certain limits, we now outline how the SEC should proceed in light of our analysis.

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[161] Notwithstanding this ambiguity, as well as the ambiguities discussed in Parts III.B.1 and III.B.2, one might nevertheless ask why enterprising plaintiffs lawyers have not at least tried to raise this issue. The likely reason is that merely acting as an unregistered investment adviser to a fund would not be sufficient to state a private cause of action under the ICA. The plaintiff would also have to allege that the fees charged by the unregistered adviser were excessive.

Unlike the IAA, the ICA contains an express private right of action allowing fund shareholders to sue the investment adviser on behalf of the fund to recapture excessive fees. 15 U.S.C. § 80a-35(b) (2018) (for a discussion of mutual fund fee litigation, see Curtis and Morley, *supra* note 102). Plaintiff's lawyers have been quite active in using this private right of action to bring claims under the ICA. *See* Quinn Curtis & John Morley, *An Empirical Study of Mutual Fund Excessive Fee Litigation: Do the Merits Matter?*, 30 J. L. Econ. & Org. 275, 282–83 (2014) (finding that excessive fee litigation is driven by plaintiff firms that file many complaints alleging a common theory of liability).

In order to prevail, a plaintiff would not merely have to persuade a court that the SEC's stance regarding index providers is incorrect. It would also have to prove that the license fee is so high that it could not be the product of arm's length bargaining. *See Jones v. Harris Assocs.*, 559 U.S. 335, 346 (2010). This would be difficult given that index providers (unless affiliated with the fund sponsor) actually do bargain at arm's length with fund complexes. This distinguishes them from typical fund advisers that are affiliates of the fund complex.

The many restrictions on investment advisers contained within the ICA, discussed in *supra* Part II.C.4, do not confer express private rights of action. Given the Supreme Court's current stance on inferring private rights of action, it is unlikely that a court would find that a fund shareholder can sue under these provisions. *See Olmsted v. Pruco Life Ins. Co.*, 283 F.3d 429 (2d Cir. 2002) (declining to find a private right of action under two sections of the ICA and discussing the evolution of the Supreme Court's jurisprudence on implied private rights of action).

There are both substantive and procedural reasons why it should adopt our proposal or something similar. Substantively, it would enable investors to compare the cost of stock selection on an apples-to-apples basis between actively-managed and index funds. It would also provide investors with adequate information about an index provider's stock selection process, including the exercise of discretion within that process. Finally, it would ensure that index providers avoid conflicting interests when composing an index. None of this would unduly upset existing arrangements between index providers and fund sponsors.

Procedurally, a safe harbor would add clarity and predictability to the SEC's enforcement stance. To see why, imagine that the manager of an actively managed small-cap mutual fund decided to re-brand the fund as an index fund and itself as an index provider rather than an investment manager. Assume it states that the index will consist of stocks selected from the 1000 smallest U.S. stocks by market capitalization, with the weights to be decided from time to time on an entirely discretionary basis by an "index committee" consisting of the existing investment professionals employed by the manager. In other words, in this thought experiment, nothing changes except the way the manager describes what it's doing.

Surely the SEC would see this for what it is—an attempt to exploit the agency's practice of not enforcing the IAA and ICA against index providers, even those that appear to meet the statutory investment adviser definitions. But where is the line? If simply calling a fund an "index fund" and the manager an "index provider" isn't sufficient, market participants need some standard by which they can tell who is an investment adviser and who isn't. Our proposal would do just that.

To accomplish these goals, the SEC should provide a safe harbor to index providers and mutual funds. The safe harbor would permit the providers of general indices to claim the status of publishers under the IAA and ICA, on the condition they and their licensees provide certain disclosures and operational protections against conflicting interests. It would treat non-qualifying index providers as sub-advisers to the fund(s) that track them. We then discuss the consequences of this regulation for mutual fund investors and the mutual fund market more broadly.

A. *How the SEC Should Proceed: A Proposed Safe Harbor*

The SEC can and should clarify the status of index providers through a safe harbor rule or interpretation (we refer to both interchangeably as a "rule" hereafter). The rule should implement a general statement that an index provider is not an investment adviser for purposes of the IAA if it does not provide personalized advice to any person and is not an investment adviser to an investment company if it does not provide personalized advice to the investment company.[162] The remainder of the rule would offer a non-exclusive, conditional safe harbor deeming an index provider not to provide personalized advice and therefore not to be an investment adviser.

The following should be considered personalized advice, making the safe harbor unavailable: (a) creating or modifying an index at the request of any licensee or prospective licensee, (b) providing any licensee, prospective licensee, or class of licensees with preferential access to information concerning changes to an index's composition or methodology, or (c) providing any licensee, prospective licensee, or class of licensees with individualized advice or information about sampling procedures for tracking the index. Taking comments or suggestions, on a non-discriminatory basis, from licensees or prospective licensees about the composition, methodology, or performance of an index without any formal or informal understanding that the provider will alter the index in response, however, should not be considered personalized advice and will not destroy the safe harbor.

Reliance on the safe harbor should be conditioned on the index provider, and any fund that directly or indirectly licenses the index, meeting certain disclosure and operational requirements. One set of disclosures would relate to costs. Any registered investment company that tracks an index should disclose, as a separate line item in the fee table included in its prospectus, any license fee the fund incurs that is not already included in the management fee.[163] The license fee would therefore either be paid by the management company and bundled into the management fee or paid directly by the fund but disclosed on the same basis as a management fee.

Another set of disclosures would be designed to inform fund investors about potential conflicts of interest. These could be included in the relevant funds' Statement of Additional Information or in a new stand-alone form the SEC could create for index providers.

The index provider should disclose its methodology, indicating where the methodology gives discretion to an individual or committee, and identifying the individual(s) exercising that discretion.[164] The index provider should be required to implement and disclose policies and procedures designed to ensure that those individuals avoid conflicting interests that might affect their discretionary decisions. The fund's trustees would be responsible for ensuring that these policies are sufficient to protect the fund's investors.

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[162] This is, for example, the structure of Regulation S under the Securities Act of 1933. *See* 17 C.F.R. § 230.901 (2019) (general statement); 17 C.F.R. § 230.903 (conditional safe harbor for certain primary distributions); *see also* 17 C.F.R. § 230.144 (2019) (including Preliminary Note outlining "basic principles" and conditional safe harbor from registration and prospectus delivery requirements).

[163] *See* S.E.C., Form N-1A, Item 3 (requiring a fee table).

[164] The purpose of the disclosure would not be to enable anyone to reverse engineer the index; providers should be entitled to treat the index as proprietary. The purpose would instead be to inform investors about the role the discretionary decisions play in the index and about any conflicts of interest that role creates.

The index provider should indicate whether it or any affiliated company is engaged in any other aspect of the securities business, such as investing, dealing, brokerage, or operating an exchange. It should further implement and describe procedures to ensure that any individual or committee exercising discretion in index composition will not do so to benefit any proprietary investment, trading position, or market.

A final set of disclosures would alert fund investors to the fact that different licensees of an index may use the index for different and conflicting purposes as described in Part I.B. The index provider should disclose, if applicable, that it licenses the index to asset managers for both tracking and benchmarking purposes and disclose the proportion of licensing fees received from each category. It should adopt and disclose a policy to prevent the underlying conflict from affecting the selection of stocks and index weights for the index.

Finally, the rule should state that an index provider that does not qualify for the safe harbor and that constitutes an investment adviser to a registered management company as defined in the ICA will be deemed a sub-adviser for purposes of the SEC's rules under Sections 10, 12, and 17 of the ICA.[165] Under those rules, an index provider would be deemed to advise only any fund or series of a fund that tracks the index. It will also constitute an investment adviser subject to registration under the IAA.

Under such a rule, the providers of single-purpose indices will generally constitute sub-advisers to the investment company tracking the index. General indices tracked by investment companies will have a choice of complying with the conditions outlined above, not complying and choosing to be treated as sub-advisers, or not complying and relying on the non-exclusivity of the safe harbor. In the latter event, the index provider or fund, as applicable, would have to persuade the SEC or the courts that the index provider qualifies for the publisher's exclusions under the IAA and ICA.

Compliance with the safe harbor would benefit both the index provider and the fund's trustees and primary manager. Because it would not be treated as an investment adviser, the index provider would avoid potential enforcement actions, disclosure and conflict of interest obligations, and civil liability under the IAA and ICA. The fund's trustees and primary manager have a fiduciary duty to the fund that extends to the selection, oversight, and fees of sub-advisers. Compliance with the safe harbor would ensure that the index provider is not a sub-adviser and thereby protect the trustee and primary adviser against a claim for breach of fiduciary duty.

The creators of some of the largest, best-known general indices, such as the S&P 500, the Russell 2000, and the MSCI World Index, also create many of the single purpose indices that our approach would treat as investment advisers. These providers would accordingly register as investment advisers under the IAA. They would also constitute sub-advisers to any fund or

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[165] *See* 17 C.F.R. §§ 270.10f-3, 270.12d-3, 270.17a-10 (2019).

portfolio for which they provide a single purpose index or other personalized advice. Alternatively, a large index provider might choose to spin off its single purpose index businesses, leaving the company free to continue its general index business under the safe harbor.

The most straightforward benefits of this approach are that it would both provide the SEC with sufficient information to keep an eye on this market—a major purpose of form ADV and the SEC's examination of investment advisers—while at the same time closing the regulatory gap that currently exists between mutual fund sub-advisers and index providers. Closing this regulatory gap is a crucial piece of rationalizing the regulatory framework.

B. Benefits to Investors and the Mutual Fund Market

The rule we have outlined would represent an improvement on the status quo. The SEC has not definitively addressed whether and when index providers are investment advisers—indeed, in both official and personal statements, SEC personnel have indicated that it is an open question. It might have been reasonable to leave the matter unresolved when indexing was in its infancy and index funds tracked only well-known general indices. Those things are no longer true. The SEC should bring clarity to a multi-trillion-dollar segment of the retail investment market.

Our proposed safe harbor rule is not the only way to bring clarity. The SEC has the authority to exclude index providers from the IAA and ICA "investment adviser" definitions if it concludes that they are not "within the intent" of those definitions.[166] We believe our approach would be better for investors and the retail fund market generally for reasons we now describe.

1. Rationalizing the Regulatory Framework

The SEC's current practice sits uneasily with the statutory framework. The providers of single purpose indices, as we have demonstrated, seem similar to sub-advisers but are regulated differently. Under the Supreme Court's approach to the publisher's exclusion, the providers of general indices should be able to claim publisher status, but only if they avoid certain conflicts of interest and misrepresentations. Our proposed safe harbor rule is attentive to just this issue. More broadly, the rule would help the SEC bring clarity to a world in which the line between indexers and active managers is becoming blurred.

As this Article has demonstrated, the differences between funds labeled index funds and those labeled actively managed funds are a matter of degree,

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[166] *See* 15 U.S.C. § 80b-2(a)(11)(H) (2018) (SEC may exclude "such other persons not within the intent of this paragraph" from IAA "investment adviser" definition.); 15 U.S.C. § 80a-2(a)(20)(v) (same; ICA definition).

not kind, with substantial diversity within each category. Some actively managed funds are "closet indexers," while some index funds are closet active managers.[167] Regulatory treatment should turn on the substance of the relationship between the index provider and the fund, not on the label the fund sponsor selects for it. The providers of single purpose indices offer the type of personalized service that is the hallmark of the adviser-client relationship. While the relevant information is not readily available, it is possible that the providers of some general indices offer personalized services to some of their licensees.

A broad exclusion for index providers would at best preserve a status quo that lacks a rational basis. At worst, it might encourage some active managers to declare themselves indexers in order to avoid undesired disclosure and substantive requirements. Our proposal, by contrast, would rationalize the regulatory framework.

2. Increase Transparency and Reduce Potential Conflicts of Interest

The rule we have outlined would also increase the transparency of the index fund market. In particular, it would facilitate apples-to-apples comparisons of the costs of active and indexed management. Active managers charge management fees that compensate them both for stock selection and administrative services. Under our approach, should an index fund's manager choose to bundle the index's license fee into its management fee, the latter will cover the same two services and be directly comparable to an active manager's fee. Should the manager choose to have the fund pay the fee directly, it would be disclosed as a separate line item rather than bundled with other operating expenses in the expense ratio. Investors and analysts could then add the license fee and management fee to create an apples-to-apples comparison between the stock-selection costs of index and actively managed funds. At the same time, fee disclosure would inform index fund investors of the portion of the expense ratio that reflects operating costs and the portion that reflects the cost of the index provider's stock selection efforts.

The rule would also help draw investors' attention to the fact that index methodologies generally include both a mechanical and a discretionary component, with the mix varying substantially from one index to another. Particularly when the discretionary component is substantial, investors should know who is exercising it and have some assurance that it is not clouded by conflicting interests. Disclosure of the procedures that the index provider has in place to ensure that the individuals responsible for creating the index do not misuse their positions, including their discretion and any proprietary information that they might have, would help investors to evaluate the extent

[167] *See* discussion *supra* Part I.B.3.

to which they should rely on the index to effectively select the fund's portfolio.

The rule would also inform investors that not all licensees use an index for the same purpose. At the extreme, an index could become a variant on the infamous Goldman Sachs "Abacus" deal in which marketing materials for a collateralized debt obligation failed to disclose the role of an investor that wished to short the underlying debt securities.[168] As with other conflicts, investors should have some assurance that the index provider has considered the problem and taken steps to address it. More generally, the rule would help educate investors about the fact that index funds are not as "passive" as they are portrayed.

Because of the tremendous diversity across index funds, there exists no single, simple way to describe their investment approaches. Basic disclosures about fund methodologies will help investors understand what they are actually getting when they buy a particular index fund.

Any index provider that registers as an investment adviser under the IAA becomes subject to SEC examination. As noted above, even the providers of many well-known general indices might register as investment advisers under the IAA by virtue of their single-purpose index business. To the extent these examinations uncover gaps in compliance, particularly with respect to managing confidential information or conflicts of interest, investors would benefit.

C. Costs

Our proposal would impose compliance costs on index providers and index funds. We believe that these would be modest and well justified in light of the benefits of the proposal.

A search of the web sites of index providers reveals substantial variation in the amount of information they reveal about index methodology. This suggests that the level of disclosure is more a question of business strategy than of cost. Some index providers already publicize employee conflict of interest policies, again suggesting that adopting and disclosing such policies will not constitute a major burden.[169] Moreover, the fact that index providers are not currently regulated as investment advisers does not insulate them from SEC enforcement actions based on misleading disclosures.[170]

An index provider that cannot or chooses not to comply with the safe harbor would not only be treated as a sub-adviser to the relevant fund or series, but would become an investment adviser for IAA purposes. Given the

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[168] *See* Consent of Defendant Goldman, Sachs & Co. at 2, *S.E.C. v. Goldman Sachs & Co.*, 790 F. Supp. 2d 147147 (S.D.N.Y. 2011) (No. 10-CV-3229).

[169] *See e.g.*, MSCI, Inc., How MSCI Manages Conflicts of Interest (Dec. 2019), https://www.msci.com/documents/1296102/16680949/How+MSCI+Manages+Conflicts+of+Interest+.pdf.

[170] *See supra* Part I.B.2.

relatively modest registration requirements under the IAA, this should not be a significant burden. In particular, we note that an adviser who only advises registered mutual funds is not required to prepare a client brochure under Part 2A of Form ADV.[171] Treatment as an investment adviser would also come packaged with fiduciary duties that, in this context, would be largely a matter of avoiding or disclosing conflicting interests. It would also impose costs associated with SEC examinations. One would hope that these examinations would be tailored to the relatively focused set of issues with index investing that we have discussed in this Article.

We also note that our proposed safe harbor is somewhat more flexible than the analogous EU rules on index funds.[172] Those rules, roughly speaking, disallow the use of what we describe as single purpose indices.[173] Our proposal allows a fund to call itself an "index" fund despite its use of a single purpose index, but treats the index provider as a sub-adviser.

Any new regulatory restrictions create a risk of discouraging entry because compliance costs are in part fixed and therefore proportionately higher for smaller firms. We note, however, that new active managers already face these start-up regulatory costs. Should implementation of our proposal result in the creation of fewer single purpose indices, this would suggest that the current market is distorted by an artificial distinction between active managers and single purpose indices that serve a similar purpose. Should the SEC observe after implementation that the largest existing index providers account for all or nearly all new single purpose indices, it could and should provide targeted relief for small firms.

Conclusion

When an index fund tracks an index, it is relying on the index provider to select the fund's portfolio. Providing this form of stock selection would normally trigger regulation under IAA. We argue that the SEC should use its rulemaking authority to clarify the status of index providers that provide an equivalent service. Index providers who provide personalized advice, including creating or modifying an index at the request of the index user, would be treated as an investment adviser for the purpose of the IAA and, if the user is an investment company, the ICA. Those who do not provide personalized advice to any person (including any investment company) would be able to

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[171] S.E.C., SEC 1707 (09-19), Form ADV Uniform Application for Investment Adviser Registration Part 2: Uniform Requirements for the Investment Adviser *Brochure* and *Brochure Supplements*, Instructions for Part 2A of Form ADV: Preparing your firm *Brochure* Item 7 and Item 1 (2010).

[172] *See* Council Directive 2009/65, 2009 O.J. (L 302) 32; European Securities and Markets Authority, ESMA/2014/937EN, Guidelines for competent authorities and UCITS management companies (2014), ESMA/2014/937EN (2014).

[173] *See id.* at 13 (disallowing use of an index "if it has been created and calculated on the request of one, or a very limited number of, market participants and according to the specifications of those market participants").

benefit from a conditional, non-exclusive safe harbor that would deem them not to be investment advisers for the purpose of the IAA and ICA. In order to benefit from this safe harbor, index providers would be required to abide by certain disclosure obligations. Our proposal would close the current gaps in the regulatory protections afforded to investors without unduly burdening the index fund market.