IOSCO Committee on Investment Management (Committee 5)

Survey on index providers for industry participants

Part A: Questions for Asset Managers:
General

1. Please outline the key jurisdictions / regulatory framework in which your firm operates.

We have index-tracking ETF fund platforms domiciled in Luxembourg and Ireland operating under UCITS (regulated by the Luxembourg CSSF and Central Bank of Ireland, respectively), as well as an index-tracking 40-Act platform in the USA. Each of the UCITS fund platforms appoint DWS Investment S.A, incorporated in Luxembourg and regulated by the CSSF, as the management company.

2. Please provide details how the costs associated with utilising a particular index / index provider are disclosed to investors in the fund / investment product. For example, please clarify if there are any circumstances under which the specific costs associated with using a particular index are broken out apart from other fees and expenses. Please outline if you are aware of any confidentiality provisions or contractual terms which may be currently imposed that would prevent such fee disclosures.

Costs paid to index providers can arise through index data license and product license agreements. Generally the majority of the costs charged are under the product license agreements. In relation to DWS European ETF platforms these costs are paid by DWS under the “fixed fee/ platform fee” portion of a fund’s TER (i.e. the ETF pays a fixed fee/platform fee to the relevant DWS entity which then pays all the costs and expenses of the ETFs, including index data and product fees, subject to certain exemptions). In relation to the US ETFs, such costs are covered under “Management fees”. We are not aware of confidentiality provisions preventing providers from disclosing index license fees to the public. Depending on the index provider, it may be difficult to attribute index costs accurately and directly to an individual ETF because:

- data license and product license usually concern one amount to be paid for access to / tracking of a series of indices not just the relevant index for a particular ETF;
- product licenses may also group several indices within a family, where index cots for such family decrease as assets managed in relation to product referencing such family of indices increase. Please note that due to this “bulk discounting” (which is in the interest of investors) and consequential lack of granularity between individual ETFs, disclosing index fees may have to be done using “up to” amounts which may not offer a level of transparency that is sufficient to justify the additional expense (also ultimately to be borne, directly or indirectly by investors) of putting such disclosures in place.

We generally agree that more transparency in terms of index fees is needed: whereas ETF fees generally go down, we find that index providers are reluctant to pass on economies of scale to their clients. Also, with the development of ESG-integrated indexing, we however see a trend where index providers tend to charge more for these indices than standard indices.

3. Where you are fully or partially responsible for the choice of an index to manage against, please outline your due diligence processes to assess the appropriateness of the index for your client/target market both at the outset and on an ongoing basis?

For each new family of Index-tracking funds we usually approach more than one provider who may be able to offer benchmarks which aim to represent the markets contemplated for the new index tracking fund. The proposals are examined from a fundamental (diversification, transparency/index rules, representativeness) as well as quantitative (performance, risk) perspective. Once a provider has been short listed as being the most appropriate, we generally require such provider to complete a questionnaire covering technical aspects of the index description, regulatory questionsand operations and data used to calculate such index family.

4. Please provide details of products where you have engaged with an index provider to create a bespoke benchmark? Please elaborate on why you would engage with an index provider to create a benchmark instead of selecting a pre-existing benchmark or opting to actively manage the portfolio. Where does the responsibility for the operational performance of the index lie contractually and where, in practice, do you think responsibility does lie?

For many ESG indices, it is common for asset managers to engage with benchmark providers to create a benchmark. Usually, a family of indices is taken as a starting point and (in the case of ESG) additional criteria such as business exclusions or active risk safeguards are added. In this example, we would require index providers to adapt their “off the shelf” index family with minimum ESG safeguards that we as asset manager suggest to our investors in our ESG product lineup. This new index family is available to the broad public for tracking and benchmarking purposes.

From the perspective of responsibility for operational performance of the index, it is irrelevant whether the index is a new index that has been created in collaboration with DWS or an “off the shelf” index. Once created any new index is the full responsibility of the index provider as index administrator and such index can be licensed to other users in the market. Although the index providers are fully responsible from a regulatory perspective for the operation, maintenance, calculation and publication of the index in line with their Benchmark Regulation responsibilities, in practice index providers include exclusions and/or caps of liability in the index data and product agreements which mean that even in cases of negligence, they are not liable to indemnify the fund for any/all consequential losses. Given the potential liability for losses could be very large if such liability is not restricted or capped, it is understandable that such entities, especially the smaller/newer ones, do this. Hence it is important for users of such indices to have sound initial and ongoing due diligence processes in place.

5. In addition to the topics / questions addressed below, are there any other areas which you think IOSCO should consider as part of its work on conduct-related index provider matters.

None to our knowledge

Response to regular and exceptional events

1. Please describe your internal governance arrangements and policies for responding to regular and exceptional events which result in challenges managing against and / or in tracking a particular index. Please separately detail these for 'regular' events (such as corporate actions, etc.) and ad-hoc exceptional events (such as external shocks such as the Russian / Ukraine market shock).

   Investment compliance teams and pricing committees are two internal structures on our side that help identify events that may result in challenges replicating an index. Our Product Governance structure examines changes to be made to products where necessary. Regular events, usually identified by investment compliance teams, can include passive investment guideline breaches such as a breach in diversification rules for indices due to the unexpected and material outperformance of an index component. The events around the war in Ukraine or the outbreak of the Coronavirus were exceptional events that challenged our tracking capabilities. Pricing committees helped determine the most responsible course of action in relation to the treatment of Russia securities in the indices. Such feedback was disseminated by DWS, in our capacity as benchmark user and market participant, to benchmark providers. In such cases, standard legal and compliance control functions were involved as well, to determine the best course of action taking into account the interests of the investors in the associated products and liaising with regulators as appropriate. Once such dialogue had taken place the management company and fund boards, as appropriate, determined the best course of action, whether it be application of certain valuation policies or suspension or amendments to the associated product.

2. Please provide details about the extent to which you engage with index providers during such events (and specifically what concrete engagement took place during the Russian / Ukraine market shock).

   See above. Usually index providers were simultaneously contacted by several market participants and held bilateral conversations as well as telephone conferences to determine the best course of action to ensure an index remained investible and representative.

3. Please also provide details of the following:
a. Did you change your processes with respect to index tracking during this period?

No

b. Please provide any information on any index changes or rebalancing holidays during this period (for example, their duration, information on the interaction and decision makingprocess around declaring a rebalancing holiday between index providers and asset managers, including how potential conflicts of interest among them may have been managed).

At the start of the pandemic in March 2020, most index providers were able to react within 10 days to the operational disruption and resulting liquidity stress in the credit markets by waiving the April rebalancing, protecting investors against prohibitive transaction costs. Concerning the Russian- Ukraine conflict, it took a similar timeframe for a consensus to emerge between index providers that Russian securities should exit indices at a price of 0 so as to enable continuous replication of global indices.

Errors

1. Did you experience any errors in the compilation of an index caused by an index provider? If so, please elaborate on the circumstances surrounding the error (e.g. the source of the error – human error, IT related, etc). What impact did this have on your business and that of the funds under management (or other underlying products as may be relevant)? For example, was there any necessity to pay financial compensation or redress of some form?

Despite index providers generally having sound operations, the application of a faulty price to a security in an index on a given day, usually due to data and IT quality issue with the index provider or one of their data providers, can generate a series of erroneous index levels until the error is recognized. While index data license agreements are generally clear that index providers are not liable for these errors, in practice the index provider may make a commercial gesture to reimburse the fund for any consequential losses. Any remaining losses may be covered by the Asset Manager if it deems it to be appropriate. Taking into account the size of certain index providers and the revenue generated from managing indices, it is not optimal that index providers exclude all liability or cap liability for their negligence. As mentioned previously. we recognize that many new index providers are trying to provide competitive pricing to benefit the ETF industry and need to exclude or cap their liabilities. In addition, index providers, especially new entrants, may not be sufficiently capitalised to cover such losses.

2. What type of arrangements (e.g. contractual or otherwise) are in place to manage such errors?

Please see above. In addition, wherever there is such an error, an incident report will be received from the index provider so that appropriate action can be taken as necessary, including, for example regulatory or investor notifications, steps to mitigate losses or improvements to processes and reporting to aim to ensure such error does not take place again.

Conflicts of interest

1. Please provide details of the extent to which you perform self-indexing and/or have an affiliated index provider. What are the potential conflicts of interest that may arise? Please also detail how potential conflicts of interest are managed in such cases (e.g., information barriers, etc.).

   DWS do not engage in self indexing.

2. Are there other situations that may give rise to potential conflicts (e.g., where an index provider invests in the fund or provides seed funding)? Please also detail how potential conflicts of interest are managed in such cases.

   We are only aware of the potential conflict of interest that an index provider may have by including its own stocks or bonds or those of an affiliate in the indices it administers. This, in our view, should not lead to any negative scenario if index rules are objective, rule-based and properly complied with. We have not witnessed any situation where an index provider or their affiliate provided fund seeding on a DWS product tracking an index from such provider in the past 5 years.

3. Do you consider that conflicts of interest may arise where both an index and an investment fund tracking that index use the same pricing information? What processes are in place to effectively manage such conflicts? Please explain the nature of the potential conflicts, how they are avoided, managed and disclosed. Where possible, please provide examples of how such conflicts were managed during recent exceptional market events.

   We are not aware of such risks.

   - As pricing information from index providers is provided after market close this mitigates the risk of asset managers accessing price sensitive information;
   - Having a pricing source hierarchy is key. Our pricing committees only noted material differences between observable prices and actual prices in indices during periods of extreme market stress where price observation was very difficult. During the Ukraine war, the price of securities provided by index providers was temporarily overruled by our valuation committee to ensure consistent pricing of securities within DWS during this uncertain time;
   - Using index provider prices for fund valuation is common throughout the whole industry, in our view. It actually reduces the risks of conflicts of interests: it increases verifiability of the price as more market participants can challenge those prices when needed.

4. Do you provide any disclosure of any affiliations or potential conflicts of interest that might arise? If so, please provide details of that disclosure.

We are not aware of any potential conflict of interest that may arise in relation to our products specifically in relation to the relationship with index providers.

Services / functions utilised

1. Please provide details of any services or functions you utilise from index providers in addition to the core function of index provision or administration. Do you consider that such services or functions raise any particular issues (e.g. conflicts, operational, etc.)?

   In the case of indices using fundamental data (factor indices, thematic indices), the information used by the index provider to construct the index composition can be very useful to investors to understand the mechanisms that drive the positions built by the index. We consider that this data should always be part of the data purchased when licensing the index, whereas index providers would generally require additional licensing fees for this service as they consider it to be an "add on".

   During the lifecycle of a specific product, DWS and index providers may from time to time organize marketing events together to promote and explain such product. In none of these circumstances did we notice any particular issue.

2. Where an index provider provides non-core services, such as Environmental, Social or Governance (ESG) screening services, do any particular challenges or difficulties arise? For example, where such screening does not form part of the index's rules, could this result in the index being less transparent? On the other hand, where such screening forms part of the index's rules, could this result in a higher level of discretion being exercised by the index providers? Are there any measures adopted by the asset managers to ensure such discretion are bounded within certain limits?

   In all of the ESG indices that are referenced by our products, ESG criteria is part of the index rules. The ESG criteria may be provided by the index provider or a third-party provider to the index provider. Such entity that is determining the ESG criteria (for example devising the rules to determine a controversies assessment or ESG rating) may have a large influence on the index composition. For large companies, this can direct substantial asset flows towards or, for the most part, away from such companies depending on their ESG evaluation pursuant to such ESG criteria. We are however not aware of any circumstance where such discretion may have been used to deliberately drive flows towards or away from a particular entity. In addition, based on the due diligence DWS has performed on such entities providing the ESG criteria, we consider that such entities have sufficient Chinese walls and/or ongoing processes of separation of company structures in place to avoid any risk that such conflict of interest may arise. We think this issue is even less likely where the index provider is using a third-party entity to provide the ESG criteria. Since the ESG regulatory and market landscape is still evolving, DWS had specific sections in its policies in relation to ESG indices to ensure that adequate due diligence is done. In addition, we make use of our internal ESG Engine which uses multiple data sources to compare ESG criteria outputs in an ESG index against ESG Engine outputs and minimum safeguard criteria before selecting an index.