Consultation Paper - Compliance Standards for Index Providers

1. Objective

To solicit the comments / views from market participants on compliance standards for index providers, to enhance greater level of transparency, promoting the reliability of benchmark determinations, addressing benchmark governance and accountability mechanisms, by providing a broad framework for index providers managing / maintaining Indices.

2. Background

2.1. To create an overarching framework of Principles for Benchmarks used in financial markets, the International Organization of Securities Commissions (IOSCO) published a report in July 2013, proposing a framework of standards for financial benchmarks (or indices) based on international best practices. The framework promotes reliability and independence of benchmark administration and addresses governance, quality, transparency and accountability issues. IOSCO report does not expect a one-size-fits-all method of implementation of the framework, nor does it restrict an administrator from adopting its own unique methodologies or adapting the methodologies to changing market conditions. IOSCO adherents are expected to either comply with the IOSCO principles or explain any non-compliance.

2.2. In addition to the principle prescribed by IOSCO, several foreign jurisdictions have articulated their own framework tailored to the requirements in their respective jurisdiction.

2.3. In light of above, it is proposed to prescribe a set of compliance standards for index providers in order to ensure quality and integrity of the indices administered, maintained or calculated by the index providers.

3. Index Methodology - Broad Market Indices (Domestic and International practices)

3.1. The broad market indices are constructed to represent the performances of large universe of companies traded on an exchange (domestic or international). Thus, the process and criteria for selection of representative stocks in such broad market indices is of critical importance. A high level summary[1] of the approaches adopted by index providers in India and internationally is briefly described below.

3.2. Stock Universe and Stock Selection Process/ Criteria

3.2.1. **Nifty 50:** (Source: https://www.nseindia.com)

Universe: Constituents of NIFTY 100 index are eligible for inclusion in the NIFTY 50 index. The Nifty 50 consists of the largest 50 stocks by free float market capitalization and liquidity, subject to stock selection criteria as given below.

Stock selection criteria:

i. Stock should be available for trading in NSE's Futures & Options segment.

ii. The company's trading frequency should be 100% in the last six months.

iii. For inclusion in the index, the security should have traded at an average impact cost of 0.50 % or less during the last six months for 90% of the observations for a portfolio of Rs. 10 crores.

iv. Companies will be eligible for inclusion in NIFTY 50 index provided the average free-float market capitalization is at least 1.5 times the average free-float market capitalization of the smallest constituent in the index.

v. As part of the semi-annual reconstitution of the index, a maximum of 10% of the index size (number of companies in the index) may be changed in a calendar year. However, the limit of maximum 10% change shall not be applicable for any exclusion of a company on account of scheme of arrangement as stated above.

3.2.2. **S&P BSE SENSEX 30:** (Source: https://asiaindex.co.in)

Universe: Constituents of S&P BSE 100 index are eligible for inclusion in the S&P BSE Sensex 30 index. The S&P BSE Sensex 30 consist of 30 largest, most liquid and financially sound companies that are listed at BSE.

[1] The information presented in this paper (unless specified otherwise) has been compiled from public available information (respective websites) of index providers / stock exchanges.

Stock selection criteria:

i. The stock must have traded on every trading day at BSE during 6 month during reference period.

ii. All companies meeting the eligibility factors are ranked based on their average 6 month float adjusted market capitalization. Top 75 companies are identified.

iii. All companies meeting the eligibility factors are ranked based on their average 6 month total market capitalisation. Top 75 companies are identified.

iv. All companies identified based on above are then combined and sorted on their annualized traded value. Companies with a cumulative annualized traded value greater than 98% are excluded

v. The remaining companies are then sorted by average 6 month float adjusted market capitalization. Companies with a weight of less than 0.5% are excluded.

vi. Remaining companies from step (v.) are then ranked based on their average 6 month float adjusted market capitalization and are selected for index inclusion according to the following rules:

   (a). The top 21 companies (whether a current index constituent or not) are selected for index inclusion with no sector consideration.

   (b). Existing constituents ranked 22-39 are selected in order of highest rank until the target constituent count of 30 is reached.

   (c). If after this step, the target constituent count is not achieved, then non-constituents ranked 22-30 are selected giving preference to those companies whose sector is underrepresented in the index as compared to the sector representation in S&P BSE All Cap.

   (d). If after this step, the target constituent count is still not achieved, non-constituents are selected in order of highest rank until target constituent count is reached.

vii. Annualized traded value is calculated by taking the median of the monthly medians of the daily traded values over the six-month period. The annualization is calculated using 250 trading days in a year.

viii. All additions and deletions are made at the discretion of the index committee.

3.2.3. **FTSE 100:** (Source: https://www.ftserussell.com)

Universe: The FTSE 100 consist of the largest 100 UK companies by full market capitalization (i.e. before the application of any investability weightings) which will qualify for inclusion in the index.

Stock selection criteria:

i. Minimum free float: To be eligible for inclusion in the FTSE UK Index Series, a security must have a minimum free float of 25% if the issuing company is UK incorporated and greater than 50% if it is non-UK incorporated. However, a new company may be initially included in the FTSE UK Index Series with a free float below the above parameters (provided it is above 5%*) where the free float is expected to meet the minimum requirements within 12 months of the company's first day of trading.

ii. Size: In order to determine index membership, all companies with eligible securities will be ranked by their full market capitalization (i.e. before the application of any investability weightings).

iii. Liquidity: Each security will be tested for liquidity by calculation of its monthly median of daily trading volume. The daily volume for each security is calculated as a percentage of the shares in issue for that day adjusted by the free float at the end of the month. These daily values are then ranked in descending order and the median is taken by selecting the value for the middle ranking day if there is an odd number of days and the mean of the middle two if there is an even number of days. Each security needs to meet the prescribed liquidity threshold in order to form part of the index.

iv. A security will be inserted at the periodic review if it rises 90th or above.

v. A security will be deleted at the periodic review if it falls to 111th or below.

3.2.4. **S&P 500:** (Source: https://www.spglobal.com)

Universe: The constituents are selected from the constituent list of S&P Total Market Index.

Stock selection criteria:

i. Eligibility market capitalization: To be included, companies must have an unadjusted mcap of US$ 8.2 billion.

ii. Public float: Investable Weight Factor (free-float factor) of a company should be at least 0.1 and must have a float market capitalization of at least US$ 4.1 billion.
iii. Liquidity: Using composite pricing and volume, the ratio of annual dollar value traded (defined as average closing price over the period multiplied by historical volume) to float adjusted market capitalization should be at least 1.0 and a stock should trade a minimum of 250,000 shares in each of the six months leading upto the evaluation date.
iv. Financial viability: Companies must have positive as-reported earnings over the most recent quarter, as well as over the most recent four quarters (summed together).
v. Sector representation: Sector balance, as measured by a comparison of each GICS sector's weight in index with its weight in the S&P Total Market Index, in the relevant market capitalization range is also considered in the selection of companies for the indices.

3.2.5. **Nasdaq 100:** (Source: https://www.nasdaq.com)

Universe: The Nasdaq 100 index is designed to measure the performance of 100 of the largest Nasdaq listed non-financial companies.

Stock selection criteria:

i. Eligibility market capitalization: There is no market capitalization eligibility criterion.
ii. Liquidity eligibility: Each security must have a minimum average daily trading volume of 200,000 shares (measured over the three calendar months ending with the month that includes the Reconstitution reference date).
iii. Seasoning eligibility: The security must have traded for at least three full calendar months, not including the month of initial listing, on an eligible exchange, which includes Nasdaq (Nasdaq Global Select Market, Nasdaq Global Market, or Nasdaq Capital Market), NYSE, NYSE American or CBOE BZX.
iv. Float eligibility criteria: There is no float eligibility criterion.
v. A Reconstitution is conducted on an annual basis, at which time all eligible Issuers, ranked by market capitalization, are considered for Index inclusion based on the following order of criteria.

vi. The top 75 ranked Issuers will be selected for inclusion in the Index.
vii. Any other Issuers that were already members of the Index as of the Reconstitution reference date and are ranked within the top 100 are also selected for inclusion in the Index.
viii. In the event that fewer than 100 issuers pass criteria (vi) and (vii) above, the remaining positions will first be filled, in rank order, by current index members that were in the top 100 at the previous Reconstitution but are ranked in positions 101-125 in the current Reconstitution.

3.3. **Calculation method and Weighting**

3.3.1. **Nifty 50:** Index is calculated on free-float market capitalization method and weightages are calculated based on the free-float market capitalization.

3.3.2. **S&P BSE Sensex 30:** Index is calculated on free-float market capitalization method and weightages are calculated based on the free-float market capitalization.

3.3.3. **FTSE 100:** Index is calculated on free-float market capitalization method and weightages are calculated based on the free-float market capitalization (adjusted for free float and foreign ownership limits where applicable to UK investors).

3.3.4. **S&P 500:** Index is calculated on free-float market capitalization method and weightages are calculated based on the free-float market capitalization.

3.3.5. **Nasdaq 100:** Index is calculated on modified market capitalization method and weightages are calculated based on the modified market capitalization.

3.4. **Review Frequency**

3.4.1. **Nifty 50:** Index is reviewed semi-annually and changes come into effect in March and September.

3.4.2. **S&P BSE Sensex 30:** Index is reviewed semi-annually and changes come into effect in June and December.

3.4.3. **FTSE 100:** The FTSE UK Index Series is reviewed on a quarterly basis and changes come into effect in March, June, September and December.

3.4.4. **S&P 500:** S&P Total Market index (parent index for S&P 500) is reviewed on an annual basis. However, S&P 500 is reconstituted at the discretion of the Committee and is based on eligibility criteria.

3.4.5. **Nasdaq 100:** Nasdaq selects constituents once annually in December.

3.5. **Stock/ Sector Weight Capping**

3.5.1. **Nifty 50:** Stock and sector weight capping is currently not applicable to this index. The index however complies with portfolio concentration norms for ETFs/ Index Funds announced by SEBI on January 10, 2019 which mandates that the weightage of any constituent in such index shall not exceed 25% and weightage of top 3 constituents in the index together shall not exceed 65% as on the last trading day of calendar quarter March, June, September and December.

3.5.2. **S&P BSE Sensex 30:** Stock and sector weight capping is currently not applicable to this index. The index would however comply with portfolio concentration norms for ETFs/ Index Funds announced by SEBI on January 10, 2019 which mandates the weightage of any constituent in such index shall not exceed 25% and weightage of top 3 constituents in the index together shall not exceed 65% as on the last trading day of calendar quarter March, June, September and December.

3.5.3. **FTSE 100:** Stock and sector weight capping is not applicable to this index. However, additional variants of the index with capping restrictions are available.

3.5.4. **S&P 500:** Stock and sector weight capping is currently not applicable to this index. However, additional variants of the index with capping restrictions are available.

3.5.5. **Nasdaq 100:** Weightage of any constituent stock cannot exceed 20% of the index and the aggregate weight of the constituents stocks whose weights exceed 4.5% cannot exceed 40%.

4. **Benchmark Indices – a representative of market**

4.1. **Attributes of Benchmark Indices vis-à-vis all listed stocks**

Nifty 50: Nifty 50 index represents 50 largest & most liquid companies and represents approximately 68% of average free float market capitalization, 59% of average total market capitalization and 57% of average daily turnover of all stocks traded at NSE for 6 months ending September 2020.

Sensex 30: Sensex 30 index represents 30 largest & most liquid companies and represents approximately 59.3% of average free float market capitalization, 49% of average total market capitalization and 34.2% of average daily turnover of all stocks traded at NSE for 6 months ending September 2020.

4.2. **Sectoral Exposure of Benchmark Indices vis-à-vis all listed stocks**
Sectoral exposure patterns of Benchmark indices are broadly in line with that of universe of all stocks listed on exchanges in India. Globally, sectoral exposure of popular indices varies depending on different geographies, nature and number of companies that constitutes the index.

4.3. **Trends in Sector exposure of Benchmark Indices vis-à-vis all listed stocks**
Various index providers follow different criteria However at a broad level, selection of stocks is primarily based upon market capitalization and liquidity by all the index providers) for selection of stocks in broad market indices in line with index methodology documents published on their websites. Across different geographies, prominence of one or two sectors is generally observed in each of the broad market indices. Any change in the weightage of a sector amongst the listed space gets reflected in the corresponding benchmark index also. Accordingly, over a period of time, sectoral representation of stocks in the indices tend to undergo a change in line with overall share of various sectors in the listed universe. Further, most of the broad market indices do not have any sector cap as the indices are supposed to reflect the performance of the listed stocks in the market. However, index providers create variants of broad market indices to offer indices that comply with the product guidelines

(generally for launch of ETFs and Index funds) which may specify sectoral or stock caps.

5. International framework in respect of benchmarks / benchmark administrators

5.1. **International practices:** Framework with respect to benchmarks / benchmark administrators, in some of the foreign jurisdictions is summarized below:

5.1.1. **European Union:** Regulation (EU) 2016/1011, *inter-alia,* aims to ensure benchmarks are robust and reliable, and to minimise conflicts of interest in benchmark-setting processes. It contains requirements for benchmark administrators, contributors of input data to benchmarks and users of benchmarks. The requirements of the aforesaid regulation are similar to the IOSCO Principles; however, it is a binding legislation. Administrators (EU and non-EU) of benchmarks that fall within the scope of the EU regulation are required to apply to their EU regulator for a license to provide such benchmark in the EU. The Regulation also applies to non-EU benchmarks (i.e. if a benchmark is used in the EU but provided by a company based outside of the EU).

5.1.2. **Australia:** In March 2018, the Corporations Act of 2001 was amended to introduce a new regulatory regime for certain benchmarks identified by ASIC as 'significant' or systemically important to the Australian financial market. ASIC has designated the following financial benchmarks as 'significant' for the purpose of the Australian benchmark regulation:

i. the Australian Bank Bill Swap Rate;
ii. the S&P/ASX 200 Index;
iii. the ASX Bond Futures Settlement Price;
iv. the Australian Interbank Overnight Cash Rate;
v. the Australian Consumer Price Index.

The benchmark administrators, as such, are subject to ASIC's Financial Benchmark (Administration) Rules 2018 and the ASIC Financial Benchmark (Compelled) Rules 2018.

5.1.3. **USA**: USA has not implemented laws specifically aimed at financial benchmarks and benchmark administrators. The manipulation or attempted manipulation of financial benchmarks are treated in the same manner as any traditional manipulation or fraudulent activity.

5.1.4. **Japan:** The Financial Services Agency of Japan cabinet office ordinance and enforcement order 2015 – introduced a limited regulation based upon the IOSCO Principles for the administrators of specified benchmarks that are widely used as the basis of financial transactions. Currently the only specified benchmark in Japan is TIBOR.

5.1.5. **Singapore:** Securities & Futures (Financial Benchmarks) Regulation 2018 / Securities & Futures (Designated Benchmarks) Order 2018 – The regulation, which came into force in October 2018, is similar to that passed by the Australian government. It uses the IOSCO Principles as its framework and limits the requirements to those benchmarks designated as significant by the Monetary Authority of Singapore. Currently the only designated benchmarks are SIBOR and SOR.

6. Proposal

6.1. Framework for Compliance Standards for Index Providers in India

Based on IOSCO principles, practices observed in the foreign jurisdictions and suitability for domestic markets, the suggested framework for Index Providers in India is as under:

6.1.1. In respect of Indices based on which any product including derivatives, Exchange Traded Funds (ETFs), Market Linked Debentures (MLDs) are available/ traded on Indian stock exchanges, stock exchanges shall ensure that:

i. The Index Provider is compliant with 'Principles for Financial Benchmarks' set out by International Organization for Securities Commissions (IOSCO), both on initial and continuous basis.

ii. The Index Provider shall get the IOSCO compliance certification from an independent third party (globally renoned audit firms or business consultant) on a bi-annual basis (once in two years) and the same should be available on its website.

iii. They enter into appropriate agreement which, inter alia, provides for the following conditions:

(a). The Index Provider shall continuously comply with IOSCO Principles for Financial Benchmarks.

(b). The Index Provider shall immediately inform the stock exchange(s) of any change in status of its compliance with IOSCO principles in case there are derivatives traded on stock exchanges based on the indices provided by the index providers. Further, on a bi-annual basis (once in two years), the Index Provider shall confirm to the stock exchange(s) regarding the status of its compliance with IOSCO principles. The aforesaid status of compliance of the Index Provider with IOSCO principles shall also be disclosed on the website of the stock exchange(s).

(c). For other products available and traded on stock exchanges including ETFs and MLDs, ETF provider/ MLD issuer shall immediately inform the stock exchange(s) of any change in status of compliance of the underlying indices with IOSCO principles. Further, on a bi-annual basis (once in two years), the Index Provider shall confirm to the ETF provider/ MLD issuer regarding the status of its compliance with IOSCO principles.The aforesaid status of compliance of the Index Provider with IOSCO principles shall also be disclosed on the website of the Product Issuer(s).

6.1.2. In respect of Indices provided by the index providers that are used by Mutual Funds for benchmarking of funds performances or issuance of Index Funds, Asset Management Company shall ensure:

i. The Index Provider is compliant with 'Principles for Financial Benchmarks' set out by International Organization for Securities Commissions (IOSCO), both on initial and continuous basis.

ii. The Index Provider shall get the IOSCO compliance certification from an independent third party on a bi-annual basis (once in two years) and the same should be available on its website.

iii. They enter into appropriate agreement which, inter alia, provides for the following conditions:

(a). The Index Provider shall continuously comply with IOSCO Principles for Financial Benchmarks.

(b). The Index Provider shall immediately inform the Asset Management Company of any change in status of its compliance with IOSCO principles.

Explanation: The index providers mentioned in point 6.1.2 above shall exclude those index providers which are already covered under point 6.1.1 above.

6.1.3. In respect of Indices which are constructed based on data provided by Indian stock exchange(s), stock exchange shall assess whether any product including derivatives, based on such Indices, available in a foreign jurisdiction hampers trading of a similar product in the Indian market. In case the stock exchange is of the view that such product available in a foreign jurisdiction hampers trading of a similar product in India, they shall terminate the existing agreement with such Index Provider.

In cases where the stock exchange decides to continue with the existing data sharing agreement or enters into an agreement, post notification of these standards, stock exchange shall ensure:

i. The Index Provider is compliant with IOSCO Principles for Financial Benchmarks, both on initial and continuous basis.

ii. The data sharing agreement entered into between stock exchange and Index Provider, shall inter alia, provide for the following:

(a). The Index Provider shall license Indices to only those jurisdictions, which fulfill the following criteria:

- The jurisdiction is a Member of Financial Action Task Force (FATF);
- The jurisdiction has not been identified by FATF as a jurisdiction with strategic AML/CFT deficiencies;
- The jurisdiction which has signed a Memorandum of Understanding (MoU) with SEBI for sharing and exchange of information;
- Any other condition, as may be specified by SEBI from time to time.

(b). If any Exchange Traded derivative, based on such Indices, is proposed to be made available in a foreign jurisdiction, the Index Provider shall seek prior approval from the concerned Indian stock exchange(s), giving appropriate justification how the product to be launched in a foreign jurisdiction would not hamper trading of any product in the Indian market. The above justification shall be assessed by the stock exchange(s) before according approval.

(c). The Index Provider shall continuously comply with the above stated conditions at 6.1.3 (ii) (a) and 6.1.3 (ii) (b) above. The Index Provider shall immediately inform the stock exchange of any change in status of its compliance with the aforesaid conditions. Further, on an annual basis, the Index Provider shall confirm to the stock exchange of the status of its compliance with the aforesaid conditions. The aforesaid status of compliance of the Index Provider with the above stated conditions shall also be disclosed on the website of the stock exchanges.

(d). Appropriate framework for termination of the data sharing agreement for:

- ➢ Breach of the aforesaid clauses of the data sharing agreement, or
- ➢ Any material impact on trading of product(s) in India arising out of aforesaid product in foreign jurisdiction.

iii. The conditions mentioned at sub-clauses 6.1.3 above shall not be applicable to issuance of any Exchange Traded Funds or similar products on an Index by any entity, subject to prior written permission of the Indian stock exchange(s) whose data may be used for creating and/ or computing the Index.

7. Public Comments

7.1. In order to take into consideration views of various stakeholders, public comments are solicited on the above proposal keeping in mind the following:

7.1.1. Whether the above Compliance Standards for Index Providers would provide for greater level of disclosure and transparency, promote the reliability of benchmark determinations, and address benchmark governance and accountability mechanisms?

7.1.2. Whether above Compliance Standards for Index Providers are sufficient to provide broad framework for Index Providers while managing/maintaining Indices including provisions for licensing indices in foreign jurisdictions?

7.1.3. Whether there is need for a formal regulatory framework for Index Providers?

7.1.4. Whether SEBI should specify certain indices as significant and apply the regulatory framework to only those indices as is done in some international jurisdictions as mentioned above?

7.2. Comments may please be emailed to Shri Sudeep Mishra, General Manager, Market Regulation Department and sent by email at sudeepm@sebi.gov.in or through post (address given below), latest by January 07, 2021, in the format below:

Details of respondent	
Name/ Organization	
Contact number	
Email address	

Comments on discussion paper	
Comments/ Suggestions	Rationale

Kindly mention the subject of the communication as "Comments on Discussion paper on Compliance Standard for Index Providers."

Postal Address:

Shri Sudeep Mishra
General Manager
Market Regulations Department
Securities and Exchange Board of India
SEBI Bhavan, Plot No. C4-A, G Block,
Bandra Kurla Complex, Bandra (East),
Mumbai - 400 051

****