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SEBI (INDEX PROVIDERS) REGULATIONS: A FORWARD LOOKING STEP

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Introduction

Owing to the mushrooming of passive funds in the past decade coupled with concerns regarding conflict of interest and governance of indices and the fact that market indices are often seen as the barometer of economic growth, it is prudent to govern index providers. Given the index regulatory vacuum for index providers (IPs) in India, the Securities and Exchange Board of India (SEBI) has been intending to regulate the conduct and functioning of the IPs for some time now. Since the publication of the draft code of conduct for IPs in 2017, SEBI has notably published consultation papers regarding compliance standards and regulatory framework for IPs. In this light, SEBI has recently notified the SEBI (Index Providers) Regulations, 2024 (Regulations) which *inter alia* aim to foster transparency in the governance and administration of indices in the securities market.

Analysis

Applicability:

Indices could either be broad market indices which reflect the general trends of the securities market or bespoke/ customized which are created to track a specific sector, industry etc. The Regulations do not make a distinction between different type of indices and aims to regulate 'significant indices' i.e. such indices which are tracked or benchmarked by domestic mutual funds and have cumulative assets under management exceeding a specified threshold. These indices were notably termed as 'public good' indices in SEBI's agenda for introduction of the Regulations. SEBI has however, exempted indices consisting only of global asset classes whether for use in the Indian securities market or elsewhere or indices for exclusive use in a foreign jurisdiction. The benchmarks regulated by the Reserve Bank of India are also exempted from the purview of these Regulations. The Regulations also do not aim to regulate other asset classes such as crypto currency, real estate etc.

Governance:

Considering that IPs can exercise discretion in creating or modifying an index which can have an impact on the volume, liquidity and price of a stock, there arises a concern regarding conflict of interest. To address this concern, it was necessary to establish certain checks and balances to regulate IPs. As a result, the Regulations prescribe an elaborate governance framework which includes constitution of an independent oversight committee formulating a conflict of interest policy and control framework:

- **Oversight committee:**

  The oversight committee is required to be distinct from the department dealing with day-to-day process of index calculation and maintenance. It is inter alia also required to review the need for change in the index design or computation methodology, introduction of new financial benchmarks, implementation of audit recommendations, procedures to be adopted in case of exercising expert judgment for use of data in a benchmark and examine whether the methodology appropriately reflects the nomenclature and description of the index.

- **Conflict of interest provisions:**

  A policy dealing with procedures to deal with conflict of interest, ensuring independence of functions performed in connection with determination of indices, exchange of information, protecting material non-public information, trading restrictions and pre-clearance requirements in respect of securities impacted by pending index changes.

- **Control framework:**

  A control framework is required to be put in place for calculating and maintaining the index. It also mandates to put in place an effective whistle blowing mechanism to facilitate early awareness of potential misconduct and support the making of disclosures by such employees who observe any unethical practice or grave misconduct.

Index formation:

The index design shall take into account factors which judiciously represents the underlying interest that the index seeks to measure, and it should exclude factors which result in distortion of the price, rate or value of that index. An IP is required to disclose: (a) the guidelines regarding the data inputs and the manner in which such data is used for the calculation and maintenance of an index; and (b) methodology documents regarding calculation and maintenance of documents. The IP is also required to disclose information regarding changes in the constituents of the index.

Code of conduct:

As mentioned above, SEBI initially in 2017 had released a discussion paper with an intent to regulate the conduct of the IPs. The proposed norms included a code of conduct for index operators, while mandating increased disclosures and greater transparency while including or excluding a stock from the indices. Additionally, the proposed measures aimed to address the issues such as avoiding conflict of interest, creating a robust audit mechanism and establishing a whistle-blower framework to ensure occurrence of potential misconduct. The erstwhile proposed suggestions were in line with International Organisation of Securities Commissions (IOSCO) principles which are globally accepted standards for IPs. The Regulations also prescribe a code of conduct for IPs which has been modelled on the IOSCO principles. The code of conduct *inter alia* provisions for maintaining the objectivity of the index, ensuring adequate disclosures, conducting periodical review, preventing the misuse of privileged information and preventing market manipulation.

International landscape:

The European Union (EU) has enacted the EU Benchmark Regulation to minimise conflicts of interest in benchmark-setting processes. The regulation includes requirements for benchmark administrators, contributors of input data to benchmarks and users of benchmarks. It also covers non-EU administrators whose index falls within the scope of EU. Similarly, Australia and Singapore have adopted an approach akin to India and regulate significant or systemically important indices.

Conclusion:

SEBI by virtue of these Regulations has taken a huge step towards fostering transparency, accountability and good governance by IPs through the enactment of these Regulations. Prior to the enactment of the Regulations, IPs operated without a specific regulatory framework and had discretion over their governance practices. It was imperative that a regulatory regime be established to govern IPs. The Regulations are yet another step in the direction of investor protection.

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