

Passive in Name Only: Delegated Management and “Index” Investing

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This Article provides the first detailed empirical analysis of the landscape of U.S. stock market indices. First, I hand collect detailed information about the universe of indices used as benchmarks for U.S. mutual funds. I document substantial heterogeneity across indices and find that the overwhelming majority of the indices in my sample are used as a primary benchmark by only a single fund. I then turn to “passive” index funds and find that both these phenomena are even more extreme among the indices that these funds track. Far from being “passive,” my findings indicate that index investing is better understood as a form of delegated management, where the delegee is the index creator rather than the fund manager. Finally, I turn to ETFs and find that a substantial fraction of these funds track indices that they or their affiliates create. Even controlling for other factors, I find that these funds have, on average, higher expense ratios. My findings shed light on an overlooked part of the financial market and have substantial implications for investor protection.

Introduction	2
II. Indices in Modern Financial Markets	5
A. <i>Indices as Benchmarks and the Rise of Index Investing</i>	7
1. Indices as Benchmarks	7
2. The Rise of Index Investing.....	8
B. <i>Indices as Managed Portfolios</i>	11
C. <i>Benchmarking Against Managed Portfolios</i>	13
D. <i>Index Investing and Delegated Management</i>	14
III. The Landscape of Indices	16
A. <i>The Sample</i>	16
B. <i>Cataloguing the Methodology Documents</i>	23

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C. <i>Index Heterogeneity</i>	28
1. Industry	29
2. Size	29
3. Style	30
a) Value/Growth	30
b) Momentum	32
c) Dividends.....	33
d) Volatility.....	34
e) Earnings and “Quality”.....	35
f) Size and Beta	36
4. “Specialized” or “Bespoke” Indices	36
D. <i>Transparency Versus Opacity</i>	37
1. Selection Criteria	37
2. Underlying Data.....	38
3. Rule Changes	38
IV.ETFs and Affiliated Indices.....	39
A. <i>About ETFs</i>	39
B. <i>Why Use an Affiliated Index?</i>	40
C. <i>The Sample and Coding Methodology</i>	41
D. <i>Affiliated Indices and ETF Fees</i>	42
V. Implications	47
A. <i>The SEC is Requiring Disclosure of the Wrong Information</i> ...47	
B. <i>Recognize that Index Investing is Delegated Management</i>49	
1. Proposal: Recognize that the Underlying Index Represents a Fundamental Attribute of an Index Fund	51
2. Proposal: Increase Index Fund Disclosures Around the Underlying Index	53
C. <i>Rethink the Use of Indices as Benchmarks</i>	55
1. Proposal: Reconsider the Benchmarking Requirement	56
2. Proposal: If the Benchmark Requirement is Retained, Require Sufficient Disclosure to Allow for Meaningful Comparisons	57
VI.Conclusion.....	57

Introduction

Securities indices are central to modern financial markets. Investors rely on indices to evaluate their investment decisions. Mutual fund managers are often rewarded based on their success in outperforming some predetermined index.¹

1. See Linlin Ma, Yuehua Tang & Juan-Pedro Gómez, *Portfolio Manager Compensation in the U.S. Mutual Fund Industry*, 73 J. FIN. 12 (forthcoming 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2024027 [<https://perma.cc/ZW8T-NHAZ>] (reporting that in a large sample of U.S. mutual funds, managers were compensated based on performance relative to a benchmark index in over 60% of fund-year observations).

Academics rely on indices to act as benchmarks in empirical research.² In recent years, their importance has only increased. With the rise of index funds—mutual funds designed to track a particular index—they are responsible for directing trillions of dollars’ worth of investments.³ They have also begun to take a more active role in corporate governance decisions. Last year, two major index providers—Standard & Poor’s⁴ (the creator of the S&P 500 index) and FTSE⁵ (the creator of the Russell 1000 index) made headlines in the financial press when they announced that they were changing their rules regarding the inclusion of firms that issue non-voting shares.

Less attention has been paid to the indices themselves. Implicitly, they are treated as passive entities, which simply *are*. With a few exceptions, most scholars and even market participants do not think too hard about where the indices actually come from. As a result, they have become something of a black box in financial markets. One notable exception to this is an article on index theory, which seeks to create a taxonomy of types of indices and describe the ways in which they are used.⁶ My Article contributes to this literature by providing the first in-depth empirical analysis of stock market indices.

In doing so, I seek to correct a pervasive misunderstanding: that stock market indices are “passive” in some meaningful sense. In a related paper, I make this point in the context of the S&P 500 stock market index.⁷ Here I take a step back and make this point in the context of the entire landscape of U.S. stock market indices. I show that there is a tremendous amount of diversity across indices, even among indices that purport to have similar aims. Far from being passive, these indices represent the deliberate decisions made by their managers.

While this observation may seem, on some level, obvious, its implications are far-reaching, and go to the heart of two of the most common uses of these indices: as performance benchmarks, and as the basis for “passive” investing.

2. See Adriana Z. Robertson & Matthew Spiegel, *Better Bond Indices and Liquidity Gaming the Rest 1* (Working Paper, Mar. 12, 2018), <https://www.hec.ca/finance/Fichier/Spiegel2017.pdf> [<https://perma.cc/T8Q3-4F6X>] (noting that “[a]sset-pricing tests, commonly used by academics to test theories about market behavior, rely on indices, as do many of the tests used in the empirical corporate finance literature”).

3. According to the Investment Company Institute, index mutual funds had net assets of almost \$3.4 trillion at the end of 2017, over \$2.7 trillion of which was in index equity mutual funds. *2018 Investment Company Fact Book*, INV. COMPANY INST. 125 (2018), https://www.ici.org/pdf/2018_factbook.pdf [<https://perma.cc/NYK6-AHW2>].

4. Press Release, S&P Dow Jones Indices, S&P Dow Jones Indices Announces Decision on Multi-Class Shares and Voting Rules (July 31, 2017), <https://www.prnewswire.com/news-releases/sp-dow-jones-indices-announces-decision-on-multi-class-shares-and-voting-rules-300496954.html> [<https://perma.cc/99YS-AM63>].

5. *FTSE Russell Voting Rights Consultation—Next Steps*, FTSE RUSSELL (July 2017), https://www.ftse.com/products/downloads/FTSE_Russell_Voting_Rights_Consultation_Next_Steps.pdf [<https://perma.cc/8KZV-YDQ5>].

6. Gabriel Rauterberg & Andrew Verstein, *Index Theory: The Law, Promise and Failure of Financial Indices*, 30 *YALE J. ON REG.* 1 (2013).

7. See generally Adriana Z. Robertson, *The (Mis)Uses of the S&P 500* (Working Paper, June 29, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3205235 [<https://perma.cc/MR3A-ZNNC>].

Robertson

When an index is used as a benchmark, it is essentially being used as baseline against which the performance of some other investment portfolio can be compared. Logically, of course, any comparison between an investment and a benchmark is as much about the benchmark as it is about the investment in question. While this is true for all indices, including the large indices that dominate the market, it is even more obvious in the context of smaller, less popular indices.

There is no shortage of such indices. I find that on average, there are five funds per benchmark index in the U.S. market, and over seventy-five percent of indices are being used as the primary benchmark by only a single fund. Not only is there a large number of these indices, I show that there is a tremendous amount of diversity across indices, even among indices that purport to have similar aims. These findings drive home the fact that, while benchmarking can be valuable, it must be interpreted with caution.

Many of these indices are also used for “passive” or “index” investing, in which the principal goal of the fund is to track the underlying index as closely as reasonably possible. As with benchmarking, the idea that such investments are “passive” reflects the pervasive misunderstanding that I seek to dispel. Rather than being passive in any meaningful sense, index investing simply represents a form of delegated management, whereby the investor (the principal) empowers a delegee (her agent) to make decision on her behalf. Instead of being truly passive, tracking an index almost always implies choosing a managed portfolio. Not only are these indices managed portfolios in the strictly financial sense, by their construction they often also imply a substantial amount of delegated decision-making authority. Seen in this light, the tremendous diversity of indices that I document should not be surprising. Just as there are a large number of “actively managed” mutual funds through which individuals delegate investment decisionmaking, there is also a large number of *indices* through which individuals engage in the same sort of delegation.

I then investigate one particularly stark example of delegated management: the phenomenon of Exchange Traded Funds (ETFs) that “passively” track an index that is *itself* created by the fund manager, or an affiliate thereof. The idea that an ETF might follow an index that it creates is counterintuitive, and, to my knowledge, is not something that has been previously documented. I refer to these as “affiliated indices,” and I investigate potential explanations for this phenomenon. I find evidence consistent with the idea that the funds in question are doing so to take advantage of the popularity of “passive” funds and are passing costs along to investors in the form of higher expense ratios.

Taken together, my results have substantial implications for investor protection and the regulation of mutual funds. Specifically, my analysis reveals substantial gaps in the current regulatory framework. Funds may be able to use their gaps to their advantage, possibly to the detriment of individual investors. My analysis therefore provides a basis for reevaluating certain aspects of the current regulatory regime, and I close by offering some recommendations.

The remainder of this Article proceeds as follows. In Part I, I discuss the role of indices in modern financial markets, including their use as benchmarks and as the basis for index investing. I also introduce the concepts of managed portfolios and delegated management. In Part II, I present the first part of my findings and document the heterogeneity across indices. In Part III, I turn to ETFs and analyze the phenomenon of affiliated indices and some potential explanations for this phenomenon. I discuss the implications of my findings in Part IV. Part V concludes.

I. Indices in Modern Financial Markets

Indices are ubiquitous in modern financial markets. In this Section, I provide a brief overview of two specific roles that they play: as performance benchmarks, and as a basis for “index” investing. In doing so, I also discuss the manners in which indices are, and are not, regulated. While indices are not directly regulated in the United States,⁸ they are often implicated by the regulatory requirements of *other* entities. I then introduce the concept of a managed portfolio, and argue that indices are best understood as managed, rather than passive, portfolios. Next, I discuss the conceptual issues associated with benchmarking against a managed portfolio. Finally, I introduce the concept of delegated management, particularly in the context of index investing. My discussions in the last two subsections foreshadow my analysis in Parts II and III, and I return to these issues in Part IV when I discuss the implications of my analysis.

Before proceeding any further in this analysis, it is useful to take a step back and ask: What is an index? When you strip everything else away, an index is simply an aggregation of different pieces of information into a single number based on some algorithm.⁹ In the context of financial market indices, an index is simply a list with two columns: a date in the first column and a number—representing either a return or a level—in the second column. From these two columns, one can plot the path—sometimes called the performance—of the index and can compare it against the performance of any other asset or portfolio. The next natural question to ask is where this list of numbers comes from. Generally, a stock market index is itself constructed from another list, also with

8. *Fast Answers: Market Indices*, SEC, <https://www.sec.gov/fast-answers/answersindiceshtm.html> [<https://perma.cc/BQ4L-YSHN>] (“The SEC does not regulate the content of these indices.”).

9. This very general definition of an index can also be used in contexts beyond financial indices. For example, corporate governance indices, which combine information on a variety of firm characteristics, are popular in the corporate finance and corporate governance literature. See Paul A. Gompers, Joy L. Ishii & Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107 (2003) (creating a “Governance Index” using twenty-four factors, including charter provisions, bylaw provisions, and other firm-level rules); see also Lucian Bebchuk, Alma Cohen & Allen Ferrell, *What Matters in Corporate Governance?*, 22 REV. FIN. STUD. 783 (2009) (proposing a refinement on Gompers et al. based on six factors). These indices assign a single number to each firm in each year.

two columns. The first contains a list of securities, while the second contains the corresponding weights associated with each security. Any time the index changes—either because the securities on the list change or because the weights associated with one or more of the securities changes, a new list is created. As such, we can think of an index as a stack of lists, one for each day.

The importance of indices in financial markets has been recognized in the academic literature since at least the mid-1980s, when Andrei Shleifer demonstrated that stocks tend to jump after being added to an index.¹⁰ Since that time, dozens of articles have been written exploring this issue and attempting to explain the reason for this effect.¹¹ Even after more than thirty years, the so-called “index inclusion” effect remains an active area of research in the finance literature.¹² In fact, the index inclusion effect is so robust that it is often used by academic economists as a means of studying *other* features of financial markets.¹³ Further evidence of the importance of indices comes from a recent paper, which shows that the way indices are typically displayed has systematic effects on financial markets.¹⁴

10. Andrei Shleifer, *Do Demand Curves for Stocks Slope Down?*, 41 J. FIN. 579 (1986).

11. Notably among these is an article demonstrating that even a purely administrative change to the weighting of index constituents resulted in a price effect. Aditya Kaul, Vikas Mehrotra & Randall Morck, *Demand Curves for Stocks Do Slope Down: New Evidence from an Index Weights Adjustment*, 55 J. FIN. 893 (2000). For a sampling of other articles in this literature, see Messod D. Beneish & John C. Gardner, *Information Costs and Liquidity Effects from Changes in the Dow Jones Industrial Average List*, 30 J. FIN. & QUANTITATIVE ANALYSIS 135 (1995); Jie Cai, *What's in the News? Information Content of S&P 500 Additions*, 36 FIN. MGMT. 113 (2007); Rajesh Chakrabarti, Wei Huang, Narayanan Jayaraman & Jinsoo Lee, *Price and Volume Effects of Changes in MSCI Indices—Nature and Causes*, 29 J. BANKING & FIN. 1237 (2005); Diane K. Denis, John J. McConnell, Alexei V. Ovtchinnikov & Yun Yu, *S&P 500 Index Additions and Earnings Expectations*, 58 J. FIN. 1821 (2003); Upinder Dhillon & Herb Johnson, *Changes in the Standard and Poor's 500 List*, 64 J. BUS. 75 (1991); Lawrence Harris & Eitan Gurel, *Price and Volume Effects Associated with Changes in the S&P 500 List: New Evidence for the Existence of Price Pressures*, 41 J. FIN. 815 (1986); Prem C. Jain, *The Effect on Stock Price of Inclusion in or Exclusion from the S&P 500*, 43 FIN. ANALYSTS J. 58 (1987); Anthony W. Lynch & Richard R. Mendenhall, *New Evidence on Stock Price Effects Associated with Changes in the S&P 500 Index*, 70 J. BUS. 351 (1997).

12. See, e.g., Nimesh Patel & Ivo Welch, *Extended Stock Returns in Response to S&P 500 Index Changes*, 7 REV. ASSET PRICING STUD. 172 (2017).

13. This is such a commonly used technique that it has spawned a small literature of its own. See Ian Appel, Todd A. Gormley & Donald B. Keim, *Identification Using Russell 1000/2000 Index Assignments: A Discussion of Methodologies* (Working Paper, Oct. 21, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2641548 [<https://perma.cc/65CL-8PCU>]. Recently, a controversy has erupted over the appropriate use of this technique. Compare Alex Young, *Will the Real Specification Please Stand Up? A Comment on Andrew Bird and Stephen Karolyi*, 15 ECON. J. WATCH 35 (2018) (highlighting concerns about the empirical methodology used in a recently published article and referring to several other recent articles relying on Russell inclusion decisions), with Andrew Bird & Stephen A. Karolyi, *Response to Alex Young*, 15 ECON. J. WATCH 49 (2018) (responding to the criticisms leveled in the aforementioned article). For the purposes of this Article, I take no position on this issue, and I mention it only to highlight an example of the central importance of indices in both academic research and financial markets.

14. Samuel M. Hartzmark & David H. Solomon, *Reconsidering Returns* (Working Paper, Nov. 8, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3039507 [<https://perma.cc/2PFJ-XKFF>].

A. Indices as Benchmarks and the Rise of Index Investing

1. Indices as Benchmarks

While financial market indices have many uses,¹⁵ in the equity market, two uses stand out: for portfolio benchmarking, and for tracking. In the former, the performance of some portfolio (for example, a mutual fund) is evaluated by comparing it to the performance of the benchmark index. In other words, a benchmark is simply a “standard against which the performance of a security or a mutual fund can be measured.”¹⁶ Indeed, in the context of the mutual fund industry, the terms “benchmark” and “index” are so closely related that the entry for “benchmark” in the Investment Company Institute’s glossary of mutual fund terms contains a cross-reference to the term “index,” and the definition of “index” reads, in part, “[a] portfolio of assets that tracks the performance of a particular financial market or subset of it . . . and serves as a benchmark against which to evaluate a fund’s performance.”¹⁷

It appears that investors take performance relative to a fund’s benchmark index into consideration in making investment decisions, and that funds in turn respond to this. For example, there is evidence that funds choose their benchmark indices strategically, and that their performance relative to their reported benchmark matters to investors *above and beyond* the overall performance of the fund.¹⁸

Recognizing the substantial benefits of relative portfolio evaluation,¹⁹ the SEC requires mutual funds to select a benchmarked index and to report performance relative to that index. Specifically, in addition to their own returns, funds that have annual returns for at least one calendar year are required to report the returns of “an appropriate broad-based securities market index.”²⁰ The choice of benchmark, however, is largely left to the discretion of the fund. According to the instructions, the definition of “appropriate broad-based securities market index” is simply an index “that is administered by an organization that is not an affiliated person of the Fund, its investment adviser, or principal underwriter, unless the index is widely recognized and used.”²¹ Importantly, this definition

15. See generally Rauterberg & Verstein, *supra* note 6.

16. *Glossary of Mutual Fund and Other Related Financial Terms*, INV. COMPANY INST. 1 (2018), https://www.ici.org/pdf/bro_mf_glossary.pdf [<https://perma.cc/E4ZN-HQFF>].

17. *Id.* at 1, 5.

18. Berk A. Sensoy, *Performance Evaluation and Self-Designated Benchmark Indexes in the Mutual Fund Industry*, 92 J. FIN. ECON. 25 (2009).

19. See, e.g., Disclosure of Mutual Fund Performance and Portfolio Managers, Investment Company Act, 58 Fed. Reg. 19,050 (Apr. 12, 1993) (adopting benchmark requirements premised on the idea that they would “give investors more information upon which to evaluate the performance of mutual funds”).

20. Form N-1A, SEC 8 <https://www.sec.gov/files/formn-1a.pdf> [<https://perma.cc/XKX5-F96P>].

21. *Id.* at 61.

places restrictions on the identity the index administrator, not on the design or function of the index itself.

Funds are also allowed, and even encouraged, to report their performance relative to additional indices. Specifically, a fund is encouraged to compare its performance to “other more narrowly based indexes that reflect the market sectors in which the [f]und invests.”²² Moreover, a fund is also permitted to “compare its performance to an additional broad-based index, or to a non-securities index (e.g., the Consumer Price Index), so long as the comparison is not misleading.”²³ Note that the instructions do not appear to restrict the order in which the benchmark indices must be presented, despite the fact that the first index may receive a disproportionate amount of investor attention.²⁴

2. The Rise of Index Investing

A second prominent use of indices—particularly in the mutual fund context—is for so-called “index investing.” In contrast to an actively managed mutual fund, where the fund manager is empowered to buy or sell assets at any time based on an overall investment strategy, index funds (sometimes called “index-based” funds or, alternatively, “passive” funds) seek to track an underlying index as closely as possible.²⁵ Index investing has taken on an increasingly important role in recent years. One recent report published by the Bank for International Settlements found that “passive funds managed about . . . 20% of aggregate investment fund assets as of June 2017, up from 8% a decade earlier.”²⁶ This rise has been particularly concentrated in U.S. equity assets, where passive funds now make up 43% of total U.S. equity fund assets.²⁷

22. *Id.*

23. *Id.*

24. Despite the prevalence of benchmarking in the investment industry, there is something rather puzzling about it. In most industries, the natural comparator for one product or service is its competitors, not some other thing called a benchmark. Regardless of whether we conceptualize mutual funds as selling products (for example, shares) or services (for example, asset management services), it is not entirely obvious why the right comparator in this industry should be qualitatively different from that norm. In the release in which it adopted its benchmarking requirements, the SEC acknowledged that it has received “several” comments urging it to permit “peer group” comparisons, arguing that “an investor wants to know how his or her fund performed in comparison with other funds having similar investment objectives.” *Disclosure of Mutual Fund Performance and Portfolio Managers*, Investment Company Act, 58 Fed. Reg. at 19,054. The SEC declined to adopt this approach, noting that “[t]he index comparison requirement is designed to show how much value the management of the fund added by showing whether the fund ‘outperformed’ or ‘under-performed’ the market, and not so much whether one fund ‘out-performed’ another. A fund could underperform a relevant market, while nevertheless comparing favorably with its peers.” *Id.* It is worth noting, of course, that these comments were made in 1993, when the landscape of stock market indices may have been very different.

25. See Off. of Inv. Educ. and Adv., *Mutual Funds and ETFs: A Guide for Investors*, SEC 19-20, <https://www.sec.gov/investor/pubs/sec-guide-to-mutual-funds.pdf> [<https://perma.cc/6DE4-5VDA>] (providing a short description of both “index-based funds” and “actively managed funds”).

26. Vladyslav Sushko & Grant Turner, *The Implications of Passive Investing for Securities Markets*, 2018 BIS Q. REV. 133, 114.

27. *Id.* at 115.

Recently, the implications of the rise of index-linked investing on financial markets has been the subject of its substantial scholarly work. One branch of this literature has focused on the potential anticompetitive effects of common ownership driven by large institutional investors and index funds, as well as potential solutions to this problem.²⁸

A second branch of this literature has emphasized a concern about the effect of index investing on corporate behavior and financial markets. In both cases, the literature is mixed. For example, in the context of corporate behavior, Lucian Bebchuk and coauthors have highlighted the governance concerns implicated by index investing,²⁹ and some scholars have found evidence that index investing affects the relationship between firm investment decisions and investment opportunities.³⁰ At the same time, other scholars have found evidence that index fund ownership actually improves corporate governance³¹ and facilitates investor activism.³² The same is true with respect to stock market implications. Here, scholars have focused on the implications of index investing for stock market price efficiency and liquidity, yielding mixed results.³³

28. This literature remains contentious. The whale in this area is José Azar, Martin C. Schmalz & Isabel Tecu, *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513 (2018). It has also led to various spinoff papers. See, e.g., Miguel Anton, Florian Ederer, Mireia Gine & Martin C. Schmalz, *Common Ownership, Competition, and Top Management Incentives* (ECGI Finance, Working Paper No. 511, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2802332 [<https://perma.cc/B2QE-4BN2>]; Miguel Anton, Florian Ederer, Mireia Gine & Martin C. Schmalz, *Innovation: The Bright Side of Common Ownership?* (Working Paper, Mar. 10, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3099578 [<https://perma.cc/LT7L-NBUZ>]. For an article suggesting a solution to these anticompetitive concerns, see Eric A. Posner, Fiona M. Scott Morton & E. Glen Weyl, *A Proposal to Limit the Anti-Competitive Power of Institutional Investors*, 81 ANTITRUST L.J. 669 (2017). Note that the initial empirical finding—that common ownership has anticompetitive effects—is not universally accepted. For a paper taking the opposite positions, see Patrick J. Dennis, Kristopher Gerardi & Carola Schenone, *Common Ownership Does Not Have Anti-Competitive Effects in the Airline Industry* (Working Paper, Feb. 5, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3063465 [<https://perma.cc/GCG5-M3LH>]. For a reply to this Article, see José Azar, Martin C. Schmalz & Isabel Tecu, *Reply to: “Common Ownership Does Not Have Anti-Competitive Effects in the Airline Industry”* (Working Paper, May 10, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3168095 [<https://perma.cc/K8CF-8TAR>].

29. Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89 (2017).

30. See, e.g., Constantinos Antoniou, Avaniidhar Subrahmanyam & Onur Kemal Tosun, *ETF Ownership and Corporate Investment* (Working Paper, Nov. 7, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3184949 [<https://perma.cc/9C8W-YQ2J>] (finding evidence that the investment decisions of firms with higher ETF ownership shares tend to be less sensitive to firm investment opportunities, as measured by Tobin’s Q).

31. Ian R. Appel, Todd A. Gormley & Donald B. Keim, *Passive Investors, Not Passive Owners* 121 J. FIN. ECON. 111 (2016).

32. Ian R. Appel, Todd A. Gormley & Donald B. Keim, *Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism* (Working Paper, June 30, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2693145 [<https://perma.cc/6GCG-QD4J>]. After a thorough analysis of the literature on the relationship between “passive” funds and governance, Fisch et al. conclude that the evidence suggests that these investors “improve both firm governance and performance.” Jill Fisch, Assaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors* 8 (ECGI Working Paper Series in Law No. 414/2018, 2019).

33. See generally Jeffrey L. Coles, Davidson Heath & Matthew C. Ringgenberg, *On Index Investing* (Working Paper, June 6, 2018),

All of this literature has taken the behavior of the indices themselves as given. In doing so, they have overlooked the fact that index investing is simply another form of delegated management.³⁴ As such, it is best understood not as a new phenomenon, but rather as the next step in the movement away from direct shareholder governance, and towards increasingly delegated decisionmaking. I discuss the implications of this in Part IV.

Before proceeding, it is worth pausing to note that it is not always entirely clear what people have in mind when they use the term “passive” to refer to index investing. It cannot simply mean that the fund manager has no, or almost no discretion in selecting securities—presumably if the fund manager had no discretion in selecting securities, but rather was required to invest in whatever the person sitting one desk over from her told her to buy, we would not think of this as being “passive.” Rather, the idea of “passive” investing has a flavor of being meaningfully rules-based: rather than picking and choosing securities, the fund is following pre-determined rules. In light of this, when the investor chooses which index fund she wants to buy, she will presumably look at the relevant rules and decide whether these are the rules that she wants her portfolio to follow. A related, albeit distinct, concept of “passivity” is the idea that, in contrast to an actively managed fund, an index fund is not trying to “beat” the market. Rather, it is simply trying to track the market, or some segment thereof. Of course, this concept begs the question of what “the market” or the “relevant segment” is.

Why would an investor be interested in investing in such a fund? One possibility is that they provide a relatively cheap means of obtaining diversification. In that case, of course, there is nothing *per se* desirable about index investing. Rather, index funds simply happen to offer, on average, relatively good diversification at relatively low costs. Of course, under this view, there is no particular reason to think of index funds as being meaningfully different from other funds, or even of distinguishing them from other types of mutual funds at all.

An alternative explanation, which takes seriously the fact that tracking an index is a material part of what makes an index fund qualitatively different from any other fund, is the possibility that index investing allows fund managers to precommit to some investment strategy. Rather than having wide discretion, by committing to following some specified index, the fund manager can credibly commit to potential investors how she will invest their money. To the extent that investors want to limit the discretion of fund managers, this constraint may be desirable to them. Of course, this constraint does not eliminate managerial discretion—rather, as Section I.D will discuss, it simply transfers it to the index creator.

https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3055324 [<https://perma.cc/29BY-QGDC>] (finding evidence that index investing introduces noise into stock prices, but no evidence that it reduces price efficiency or liquidity).

34. See discussion *infra* Section I.D.

B. Indices as Managed Portfolios

Despite the ubiquity of indices and the rich literature focusing on their effects, there has been little work done on indices *qua* indices. Moreover, despite the central role indices play in modern financial markets, little is known about how they go about selecting which securities to include or exclude.³⁵ To the extent that financial economists have paid any attention to the decisions made by index providers, it has generally been to note in passing that some indices—notably the Russell 1000 and 2000—operate via fairly mechanical rules, whereas others involve some amount of discretion.³⁶ Similarly, despite the fact that indices are both plentiful and ubiquitous, no generally accepted method exists for comparing the performance of one index to another.³⁷ While the ideal benchmark for the purposes of academic finance may be one that is as close to a pure “buy-and-hold” portfolio as possible,³⁸ this may or may not be true in other contexts. Even if it is true in theory, in practice, after examining hundreds of indices, I found none that were truly passive. Rather, *all* of them represent managed portfolios in that sense.

What do I mean when I say that some index is a managed portfolio? In contrast to a buy-and-hold portfolio, a managed portfolio is one in which some trading occurs.³⁹ A buy-and-hold portfolio is precisely what it sounds like: the portfolio manager simply selects securities and weights at day one, forms her portfolio, and then sits back and waits. No trading, rebalancing, or other activity of any kind occurs. This is not to say that *no* management or stock-picking occurs. After all, the manager had to decide what stocks to include in her portfolio, and in what proportions, at day one. The passivity kicks in after day one, where no further action is taken.

It is important to note that there can be tremendous diversity across managed portfolios. For example, one can distinguish between a purely rules-based managed portfolio and an actively managed portfolio. A portfolio that consists of the 100 largest stocks on the New York Stock Exchange (NYSE) would be a managed portfolio—as stocks change in size, the composition of the portfolio would change. The fact that the changes occur entirely by operation of a preset rule doesn’t change the fact that the portfolio is changing. Alternatively,

35. One notable exception to this is work by Rauterberg and Verstein, which provides a systematic overview of how indices are used and proposes a taxonomy of financial indices. Rauterberg & Verstein, *supra* note 6, at 1. Rauterberg and Verstein also emphasize the subjectivity and human discretion element that goes into indices, highlighting what they call “the myth of objectivity.” *Id.* at 5. This Article builds on their theoretical insight by providing the first systematic empirical evidence of the landscape of stock market indices.

36. See discussion *supra* note 13 and accompanying text.

37. Robertson & Spiegel, *supra* note 2, at 4 (noting that the authors “are aware of no standard method for comparing one index’s accuracy to another,” before proposing and implementing a series of tests).

38. *Id.* at 1 (arguing that “[a]ny good benchmark should represent a passive strategy that can be followed without any special knowledge”).

39. See JOHN H. COCHRANE, ASSET PRICING 134-135 (rev. ed. 2005).

a manager might have discretion to select individual stocks for her portfolio, based on whatever criteria she sees fit, including her own intuition about future performance. The difference between this portfolio and the portfolio of the 100 largest stocks on the NYSE is that while the latter is a managed portfolio, the former is an *actively* managed portfolio.

Based on the preceding discussion, it should be clear that indices are, in general, managed portfolios. Even assuming that the index methodology stays constant, the composition of securities on the index changes over time according to that methodology. Indeed, after analyzing the entire universe of indices that are used as benchmarks for U.S. mutual funds, I did not find a single index that follows a pure buy-and-hold strategy: all of them are, at the very least, managed portfolios.⁴⁰

As it turns out, however, index methodologies *do* tend to change over time. To take just one example, the methodology for the S&P 500 changed at least eight times between January 1, 2015, and April 30, 2018,⁴¹ and overall, the methodologies of this family of indices⁴² changed 22 times within that period.⁴³ The S&P is not unique in this regard. For example, the methodology employed in constructing the Russell U.S. Equity indices was modified 4 times between July 2017 and May 2018.⁴⁴ Together, the indices in these families comprise a disproportionate share of the market for benchmark indices. As shown in more detail below in Section II.A, they represent 18 of the 20 most popular benchmark indices by number of funds, and 15 of the 20 largest by assets under management (“AUM”).⁴⁵

Not only do methodologies change over time, they often also explicitly grant the index creator some amount of discretion. Sometimes this discretion is relatively narrow—for example, in interpreting a rule for edge cases. Other times, the discretion is much broader, such as in the case of the Dow Jones

40. See *infra* Part II.

41. S&P DOW JONES INDICES, S&P U.S. INDICES METHODOLOGY 35-37 (Apr. 2018) (on file with author).

42. By family of indices, I mean related indices created by a single index provider. For example, the S&P 500, S&P MidCap 400, and S&P SmallCap 600 are all part of the same family of indices. This is distinct from a *fund* family. For a detailed analysis of the incentives of fund families, including their incentives with respect to index funds, see Fisch et al, *supra* note 32.

43. S&P U.S. INDICES METHODOLOGY, *supra* note 41. While some of these rule changes are quite minor, others represent material changes to the construction of the index. For example, on July 31, 2017, S&P Dow Jones Indices announced that the S&P Composite 1500 and its component indices (which includes the S&P 500) would no longer add companies with multiple share class structures. *Press Release, S&P Dow Jones Indices, supra* note 4. For a more detailed discussion of changes to the S&P 500 methodology, see generally Robertson, *supra* note 7.

44. See FTSE RUSSELL, RUSSELL U.S. EQUITY INDEXES: CONSTRUCTION AND METHODOLOGY UPDATE 1 (July 28, 2017) (on file with author); FTSE RUSSELL, RUSSELL U.S. EQUITY INDEXES: CONSTRUCTION AND METHODOLOGY UPDATE 1 (Oct. 20, 2017) (on file with author); FTSE RUSSELL, RUSSELL U.S. EQUITY INDEXES: CONSTRUCTION AND METHODOLOGY UPDATE 1 (Dec. 1, 2017) (on file with author); FTSE RUSSELL, RUSSELL U.S. EQUITY INDEXES: CONSTRUCTION AND METHODOLOGY UPDATE 1-2 (May 3, 2018) (on file with author).

45. See *infra* Table 2.

Industrial Average, which, as discussed below,⁴⁶ has no quantitative rules for selecting constituents.⁴⁷ Others still contain enough ambiguity so as to make it difficult for a third party to determine exactly how the index will be constructed going forward.⁴⁸ The most extreme examples of these are indices that rely on proprietary methodologies.⁴⁹

This argument—that indices are managed portfolios—is perhaps counterintuitive. Perhaps because of the ubiquity of the idea of “passive investing”—i.e., an investment strategy in which the investor attempts to invest in a way that tracks some index—indices have come to be associated with passive portfolios. Of course, these are false friends: the fact that an investor “passively” follows an index does not imply that the index *itself* is passive.⁵⁰

In the next two subsections, I introduce the conceptual implications of this insight in the context of benchmarking and index investing, respectively. I leave a more detailed discussion of the implications of my findings for Part IV.

C. Benchmarking Against Managed Portfolios

It should be fairly straightforward to see why this insight is relevant in the context of benchmarking. First, given that no index is truly passive, in the sense of being a pure buy-and-hold portfolio, any comparison between an investment portfolio and an index necessarily implies a comparison with a managed portfolio. Sometimes this may be precisely the right thing to do. For example, an investor who is herself holding a managed portfolio could be entirely correct in comparing its performance to that of another managed portfolio. In that case, by comparing the performance of her portfolio to the benchmark, she can answer the question of “how did my managed portfolio do compared to this other managed portfolio?” She is, in other words, comparing one type of management to another.

In contrast, an investor who has chosen to invest in a truly passive fashion—by buying securities and simply holding them—and who compares his performance to that of an index is asking something quite different. In fact, he is asking two questions: “How does the performance of my passive portfolio compare to that of a managed portfolio?” and “How does the performance of my portfolio compare to that of *this particular* managed portfolio?” While the second one is the same as above, the first is not. In general, managed portfolios

46. See *infra* Section II.D.1.

47. S&P DOW JONES INDICES, DOW JONES AVERAGES METHODOLOGY 3, 5 (Apr. 2017) (on file with author).

48. See *infra* Section II.D.

49. See *infra* Section II.C.4.

50. People can also actively trade in “passive” funds, such as ETFs, further muddying the waters of “passive” investing. I leave this possibility aside and focus on the “passivity” of the indices themselves and of the funds that track them.

Robertson

will outperform passive portfolios over long horizons,⁵¹ leading to biased comparisons.⁵²

This leads to the second critical issue related to benchmarking—that any comparison against a benchmark is as much about the benchmark as it is about the comparator. While the old adage refers to a comparison between apples and oranges, one could just as well speak of comparing oranges to apples. In the context of mutual funds or stock portfolios, this implies that it is crucial to select an appropriate benchmark index before making any comparisons. Naturally, in order to do so, one must first understand the details of the benchmark index. Otherwise, any comparison is, at best, useless, and at worst, misleading. I return to this issue in Section IV.C.

D. Index Investing and Delegated Management

The basic idea of delegated management is quite simple: in the abstract, it simply means that rather than making all the relevant decisions alone, one retains a delegee, or an agent, to make decisions on one's behalf. In the corporate context, this is the familiar story of the separation of ownership and control.⁵³ Rather than running the company themselves, investors elect board members, who hire managers to run the company's day-to-day activities.⁵⁴

Investors can do something similar at the portfolio level: rather than personally managing their security portfolios, they can retain a manager to do it for them, for example, by buying shares in some sort of fund, such as a hedge fund or an actively managed mutual fund. By doing so, the investors are delegating the decisions around which stocks to buy and sell (and in what quantities), and when to do it, to the fund manager. Alternatively, an investor could purchase an index fund, which tracks some underlying index. Here, the buying and selling decisions are taken out of the hands of the managers.⁵⁵ Instead of the fund manager, these decisions are simply being made by the index providers. Somebody is still making the decisions, and delegated management is still occurring.

While individuals may be happier not having to manage the day-to-day features of their financial lives, delegated management almost invariably leads to concerns about agency problems. These problems are well known and well understood. Much of the literature on corporate law and corporate governance is focused on identifying and remedying agency problems, and one of the primary

51. See COCHRANE, *supra* note 39, at 132-136.

52. See generally Robertson, *supra* note 7 (quantifying the extent of that outperformance in the context of the S&P 500).

53. See Roberta Romano, *Preface*, in FOUNDATIONS OF CORPORATE LAW, at v (2d. ed. 2006) (“The key feature of the public corporation is Adolph Berle and Gardiner Means’ insight concerning the separation of ownership and control: managers of the firm, who run the business, are not the owners.”).

54. *Id.*

55. This is not entirely true. Even in a “passively” managed fund, fund managers still have some discretion (generally to reduce transactions costs and tracking error), but it is relatively minor.

purposes of corporate law is addressing and minimizing these problems.⁵⁶ While running a company is more complex than managing a stock portfolio, the same types of concerns can arise in the portfolio management context.

Not all delegation is delegated management. The “management” portion of delegated management implies some discretion or decisionmaking by the agent that is not predetermined or directly supervised by the principal—here, the investor. For example, if an investor wrote a complete contingent list of investment rules and asked the manager to implement those rules, it would be odd to call that delegated management. The “manager” in that example would simply be executing the instructions. Similarly, if the investor instructed the fund manager to track a particular index, and the investor knew exactly what that index was going to do on any given day and under any given set of circumstances, it would be strange to think of this as delegated management. The investor need not even have written the rules herself. Suppose instead that she simply selected the index from a menu of index offerings, each of which followed clear mechanical rules that she fully understood. Here again, all the managerial decisionmaking—as far as the investor’s portfolio is concerned—is done at the moment that the investor selects which of the indices she wants her fund manager to track. If the index rules are clear and mechanical, the rules do not change, and the index creator has no meaningful decision-making authority, we would not think of tracking that index as delegated management.

While in theory it would be possible to construct an index with those characteristics—an index that is purely mechanical and fully transparent *ex ante*—after reviewing the methodology documents of over 600 indices, I did not find a single one that operated in that way.⁵⁷ Rather, as discussed in Part II, many either provided for substantial amounts of discretion, or were described in such a way as to make it virtually impossible for a third party to precisely interpret the stated criteria.

This observation has substantial implications, both conceptual and concrete. While there is nothing inherently wrong with delegating managerial decisionmaking,⁵⁸ it is important to recognize that this is what investors are doing when they engage in index investing. I return to this issue in Section IV.A, with a particular focus on the implications for investor protection. Before doing so, I turn to the empirical portions of this Article.

56. Romano, *supra* note 53, *Preface* (noting that “[m]uch of corporate law is directed at mitigating agency problems”).

57. As discussed in more detail below, there is nothing inherently wrong with delegated management; it is simply something that must be recognized and treated accordingly. *See* discussion *infra* Part IV.

58. *See* discussion *infra* Part IV.

II. The Landscape of Indices

While even many relatively financially sophisticated individuals would be hard pressed to name more than a handful of indices, it turns out that there are thousands of different securities indices in the world,⁵⁹ hundreds of which focus on U.S. equity securities. In a related paper, I perform a detailed quantitative analysis on the giant among these—the S&P 500—and look at the implications of its security selection decisions. Repeating this analysis for each of these other indices is infeasible for both practical and technical reasons.⁶⁰ Instead, in this Section, I take a different approach. Rather than delving into the *implications* of security selection, I take a step back and examine the security selection *process* itself. In other words, this Section builds on the idea of indices as managed portfolios and explores the differences in *how* these portfolios are managed. I do so with two aims in mind: (1) to explore *why* there is such a profusion of indices, and (2) to shed light on *how* the indices differ from each other, if at all. In doing so, I hope to shed some light on this previously unexplored landscape.

A. The Sample

To ensure that my sample was as comprehensive as possible, I began by casting a wide net. Using data from Morningstar Direct, on July 26, 2017, I obtained a list of all equity mutual funds available for sale in the United States. Morningstar Direct is marketed as “an investment analysis platform built for asset management and financial services professionals”⁶¹ and is also used by academics in the finance literature.⁶² This list included open-ended equity mutual funds, ETFs, and closed-end funds. In order to ensure that I did not miss anything, I also included open- and closed-end funds, as well as ETFs available for sale in the U.S. that were classified by Morningstar Direct as “Alternative”

59. A search of Morningstar Direct on August 3, 2017, returned over 67,000 indices, including equity indices, fixed income indices, and “alternative” indices. Even after aggressively eliminating duplicates—for example, instances where the same index was offered in different currencies—I was left with about 29,000 indices. There were a total of 307 index creators in my sample, and the average index creator in my sample is associated with 95 indices, with a median of 5, indicating a highly skewed distribution. 145 of these creators have at least one equity index, with a mean of 59 indices per creator and a median of 3, exhibiting a similarly large skew. This high degree of skewness means that while a relatively small number of index providers dominate this market (FTSE/Russell, MSCI and S&P in the equity market, and Bank of American/Merrill Lynch, Bloomberg/Barclays, Citi and Markit in the fixed income market), there are also hundreds of smaller providers. In total, 282 index providers appeared fewer than 100 times in the data, and 206 appeared fewer than 10 times.

60. Practically, doing so would require a large amount of data cleaning and computing power. Technically, unlike S&P, most index providers in my sample do not make the historical constituents of their indices available.

61. MORNINGSTAR DIRECT, <https://www.morningstar.com/products/direct> [https://perma.cc/AR3Y-T3SD].

62. For a recent example, see Martijn Cremers & Ankur Pareek, *Patient Capital Outperformance*, 122 J. FIN. ECON. 288, 291 (2016) (classifying as “active share managers” those who manage funds whose holdings differ substantially from their benchmark as reported on Morningstar Direct, and finding that among these funds, those who trade infrequently outperform those who do not).

or “Miscellaneous,” or whose type was missing. Because this last group introduced a wide variety of different types of funds that were not focused on equities, I then removed funds that had a Morningstar category that clearly indicated that they were not equity funds.⁶³

Because I was interested in limiting my attention to the U.S. market, I dropped all funds that Morningstar categorized as focusing on foreign markets.⁶⁴ I then went through the remaining indices and eliminated funds that were benchmarked to indices that were clearly either non-U.S. focused or were not equity indices.⁶⁵ Finally, because I was interested in the relationship between

63. Specifically, I dropped funds in the following Morningstar categories: “Alt - Fund of Funds – Multistrategy,” “Alt - Fund of Funds - Other,” “Alt - Fund of Funds - Europe,” “Managed Futures,” “Miscellaneous - Income and Real Property,” “Multicurrency,” “Option Writing,” “Single Currency,” “Trading - Leveraged/Inverse Commodities,” “Trading - Inverse Commodities,” “Trading - Inverse Debt,” “Trading - Leveraged Commodities,” and “Trading - Leveraged Debt.”

64. Specifically, I dropped all funds in the following Morningstar categories: “Asia Pacific Equity,” “China Region,” “Diversified Emerging Mkts,” “Diversified Pacific/Asia,” “Emerging Markets Equity,” “Europe Stock,” “European Equity,” “Greater China Equity,” “India Equity,” “Japan Stock,” “Latin America Stock,” “Pacific/Asia ex-Japan Stk,” “Asia Pacific ex-Japan Equity,” “Foreign Large Blend,” “Foreign Large Growth,” “Foreign Large Value,” “Foreign Small/Mid Blend,” “Foreign Small/Mid Growth,” “Foreign Small/Mid Value,” “Global Emerging Markets Equity,” “Miscellaneous Region,” “Other Asia-Pacific Equity.” I also dropped funds to which Morningstar assigned a country category “Europe.”

65. The funds I dropped were those that were benchmarked to the following indices: “BBgBarc Capital US Agg Bond TR USD,” “Barclays US Tr 2Y/10Y Yield Curve TR USD,” “Bitcoin Market Price PR USD,” “BofAML 3M Trsy Bill +3% Wrap,” “BofAML US Treasury Bill 3 Mon TR USD 50.00000% + MSCI World NR USD 50.00000%” “FTSE 3-month U.S.T-Bill + 4% USD,” “Hartford Risk-Optim Multif REIT TR USD,” “JPY USD,” “8JPY/USD TR USD,” “MSCI US REIT USD,” “3-Month LIBOR,” “BBgBarc 1-3 Yr US Treasury TR USD,” “BBgBarc Global Aggregate TR Hdg USD,” “BBgBarc Global Aggregate TR USD,” “BBgBarc Municipal 5 Yr 4-6 TR USD,” “BBgBarc Municipal TR USD,” “BBgBarc US Agg Bond TR USD,” “BBgBarc US Corporate High Yield TR USD,” “BBgBarc US Govt/Credit TR USD,” “BBgBarc US Treasury Bill 1-3 Mon TR USD,” “BBgBarc US Trsy Bellwethers 3Mon TR USD,” “BBgBarc US Trsy Infl Note 1-10Y TR USD,” “BONY China Select ADR TR USD,” “BONY Emerging Markets 50 ADR TR USD,” “BONY Latin America 35 ADR TR USD,” “BofAML US Treasuries 1-5Y Yld USD,” “BofAML US Treasury Bill 3 Mon TR USD,” “BofAML US Treasury Bills 0-3 Mon TR USD,” “BofAML US Treasury Bills TR USD,” “BofAML USD LIBID 1 Mon Average TR USD,” “BofAML USD LIBOR 3 Mon CM,” “BofAML USD LIBOR 6 Mon CM TR USD,” “Citi Treasury Bill 1 Mon USD,” “Citi Treasury Bill 3 Mon USD,” “DJ US Select REIT TR USD,” “FTSE EPRA/NAREIT Developed Europe NR USD,” “FTSE EPRA/NAREIT Developed Ex US NR USD,” “FTSE EPRA/NAREIT Developed Ex US TR USD,” “FTSE Developed Europe All Cap NR USD,” “FTSE EPRA/NAREIT Dv ex NA NR USD,” “FTSE EPRA/NAREIT Global Ex US TR USD,” “FTSE EPRA/NAREIT Global REITs NR USD,” “FTSE NAREIT All Equity REITs TR USD,” “FTSE NAREIT All REITs TR,” “FTSE NAREIT Equity REITs TR USD,” “ICE LIBOR 1 Month USD,” “ICE LIBOR 3 Month USD,” “MSCI ACWI Ex USA IMI NR USD,” “MSCI ACWI Ex USA NR USD,” “MSCI Brazil 25-50 GR USD,” “MSCI Brazil 25-50 NR USD,” “MSCI India NR USD,” “MSCI Japan GR USD,” “MSCI Japan NR USD,” “MSCI Korea 25-50 NR USD,” “MSCI Mexico IMI 25-50 GR USD,” “MSCI Mexico IMI 25-50 NR USD,” “MSCI US REIT GR USD,” “MSCI US REIT NR USD,” “MVIS Russia NR USD,” “S&P Dev Ex-US BMI Energy Sector NR USD,” “S&P Dev Ex-US BMI FinancI Sector NR USD,” “S&P Dev Ex-US BMI HealthCare Sec PR USD,” “S&P Dev Ex-US BMI IT Sector NR USD,” “S&P Dev Ex-US BMI Industrial Sec NR USD,” “S&P Dev Ex-US BMI Materia Sector NR USD,” “S&P Dev Ex-US BMI Telecom Svc Se NR USD,” “S&P Dev Ex-US BMI Utilit Sector NR USD,” “S&P Dev ExUS BMI ConsDiscret Sec NR USD,” “S&P Developed Ex US Property NR USD,” “S&P Developed Ex US Property TR USD” “S&P Developed Property TR USD,” “S&P Developed Small TR USD,” “S&P Dvlp Ex US Consumer Staple GR USD,” “S&P Global Ex US Property NR USD,” “S&P Global Ex US REIT NR USD,” “S&P Global REIT NR USD,” “S&P Global REIT TR USD,” “US Dollar,” “USTREAS Federal Funds,” “Wilshire US REIT TR USD,” “Wilshire US

Robertson

funds and their benchmark indices, I then dropped all funds for which no benchmark index was recorded.

After eliminating duplicates, this left a total of 897 indices. With the help of a research assistant, I then obtained the methodology document associated with each index. In a few cases, no formal methodology document was available. In such cases, I relied on other publicly available sources to obtain the required information.⁶⁶ I then read through each methodology document. Based on this review, I identified 83 of these as indices that are primarily composed of non-stock assets,⁶⁷ and another 213 as indices that are primarily or exclusively composed of non-U.S. equities or are designed to cover regions that extend beyond the United States.⁶⁸ This leaves a total of 601 indices, which benchmark 3,206 mutual funds (for a total of 9,091 fund-classes).

Table 1: Summary Statistics – Indices (Full Sample)

	Mean	Standard Deviation	Percentile					Number of Indices
			10 th	25 th	50 th	75 th	90 th	
Number of Funds	5.33	38.52	1	1	1	1	3	601
Aggregate AUM (millions)	16,183	170,682	5	36	267	1,641	9,166	601

This table presents the distribution of number of funds by index, as well as the aggregate AUM invested in funds (in millions of dollars) by index. The first column presents the average number of funds per index, as well as the average total AUM per index. The second column presents the standard deviations of the same. The third through seventh columns present the 10th, 25th, 50th (i.e., the median), 75th, and 90th percentiles of the distributions.

RESI TR USD,” “WisdomTree Gbl Ex Us Real Estate TR USD,” “DJ Gbl Ex US Select RESI NR USD,” “AUD/USD TR USD,” “Double Long Euro TR USD,” “Double Short Euro TR USD,” “EUR/USD TR USD,” “FTSE China 50 NR USD,” “FTSE China 50 USD TR USD,” “FTSE Developed Europe All Cap TR USD,” “MSCI Europe NR USD,” “MSCI Europe Small Cap NR USD,” “MSCI Europe/Financials NR USD,” “WisdomTree Gbl ex-US Hdg Real Es TR USD.”

66. For example, in some cases, no formal index methodology document was available, but a description of the index was available on the index provider’s website. In other cases, a prospectus for an associated ETF was available, and I was able to obtain methodology information from the prospectus. In other cases, a factsheet or other description file relating to an ETN or ETF was available, which contained information on the underlying index. After all this, there were three indices that remained. For one, the “Barclays Long/Short Equity Index,” I relied on a short description of the index provided by the fund that was using it as an index to characterize it as a specialized index. The two remaining were the “BofAML Technology 100” and the “S&P United States Property” indices. Based on their names, I inferred that both were industry indices. I made no inferences about the other characteristics of these indices. My results are not sensitive to the exclusion of these indices.

67. For example, some of these indices primarily track assets like ETFs, MLPs, or REITs. Others are indices of hedge funds, or of other indices.

68. For these purposes, I treat equities listed on U.S. exchanges are U.S. equities. As such, an index that includes foreign equities that are traded on U.S. exchanges, including in the form of ADRs, is included in my sample. In contrast, an index that includes securities listed on “developed country exchanges,” is excluded, since it includes foreign equities listed on foreign exchanges. I also exclude indices designed to track equities that represent regions that extend beyond the United States, including “World,” “Developed Countries,” and “North America.” I also identify and remove a few indices that exclude U.S. firms that were missed in prior screens.

Table 1 presents summary statistics on the number of funds, as well as the aggregate AUM benchmarked to each index. Table 2 presents the most popular indices, measured both by number of funds that use it as a benchmark and by the aggregate AUM of the funds benchmarked to it.

Table 2: Most Popular Indices (Full Sample)

Most Popular Indices by Number of Funds		Most Popular Indices by AUM	
Index Name	Number of Funds	Index Name	Aggregate AUM (billion)
S&P 500	842	S&P 500	\$3,989
Russell 2000	234	CRSP U.S. Total Market	\$797
Russell 1000 Value	188	Russell 1000 Value	\$603
Russell 1000 Growth	183	Russell 1000 Growth	\$532
Russell 2000 Value	134	Russell 2000	\$328
Russell 2000 Growth	118	Russell Mid Cap Value	\$204
Russell Mid Cap Growth	82	Russell Mid Cap Growth	\$203
Russell Mid Cap Value	81	Russell 3000	\$186
Russell 3000	80	Russell 2000 Value	\$181
Russell 1000	79	Russell 1000	\$178
S&P MidCap 400	56	S&P MidCap 400	\$155
Russell 2500	54	Russell 3000 Growth	\$138
Russell Mid Cap	48	Russell 2000 Growth	\$131
Russell 3000 Value	43	CRSP U.S. Mid Cap	\$110
Russell 3000 Growth	40	Russell Mid Cap	\$101
Russell 2500 Growth	30	CRSP U.S. Small Cap	\$97
Russell 2500 Value	27	CRSP U.S. Large Cap Growth	\$83
NASDAQ 100	22	Russell 3000 Value	\$83
S&P SmallCap 600	22	NASDAQ 100	\$76
DJ Industrial Average	16	S&P Completion	\$73
Total number of funds	3,206	Total AUM	\$9,726

This table presents the twenty most popular indices within the sample, as measured by the number of funds using the index (left panel) and the aggregate AUM (in billions of dollars) invested in funds using the index (right panel). The last row of each panel presents the total numbers of funds and AUM associated with these twenty indices.

Table 2 highlights the dominant position of the S&P 500 in this market. Out of a total of 3,206 funds, 842 (26%) are benchmarked to the S&P 500. This dominance is even greater in AUM terms, where the figures are almost \$4 trillion, or 41% of the total. Of course, that still leaves over \$5.7 trillion, and almost 2,400 funds, benchmarking to some *other* index. Moreover, as Table 1 demonstrates, there is a long tail of indices. The median index—and even the

75th percentile index—is being used by only a single fund,⁶⁹ and even the 90th percentile is only being used by 3 funds, highlighting the tremendous skew in the data. That being said, even the smaller indices are associated with nontrivial amounts of money. The aggregate AUM associated with the median index is \$267 million, and there are 193 indices that are associated with over \$1 billion in AUM. While they are clearly not as large as the S&P 500, these amounts are large enough that they should not be ignored.

Because indices can act both as benchmarks and as an underlying index for the purpose of “index” investing, I divide my sample of mutual funds into index funds and non-index funds.⁷⁰ Then, recognizing that an index fund could potentially track an index other than its primary prospectus benchmark, I obtained the prospectus for each index fund from the SEC’s EDGAR Mutual Fund database and hand-collected the underlying index for each fund.⁷¹ Out of 912 index funds, I was able to locate prospectuses for 889 in this way.⁷² Twenty-two of the remaining twenty-three were Exchange-traded notes, and I obtained their prospectuses by other means, such as through the Morningstar website. The final one was a unit investment trust, and I obtained its prospectus from EDGAR.⁷³ I omitted one fund because it was an actively managed ETF, and therefore not have an underlying index. I was therefore left with a final sample of 911 index funds. The set of non-index funds consisted of the remaining 2,294 funds.

To investigate the characteristics of indices used as benchmarks for actively managed mutual funds separately from the characteristics of indices used for “index investing,” I repeat the analysis in Table 1 and Table 2, this time splitting the sample between the two groups. I note that while I am relying on the Morningstar Direct data for the non-index fund subsample, I use my hand-collected data for the index fund subsample. As a result, the data used in the two subsamples does not aggregate to the data used in the full sample. The results are presented in Table 3 and Table 4. Because some indices are used *both* as the benchmark for a non-index fund and as the underlying index by an index fund, these two groups overlap. Moreover, because it is possible for a fund to *track* an

69. This figure actually understates this phenomenon. In fact, 477 indices were being used by a single fund, representing 79.4% of the total. An additional 56 indices were used by only 2 funds, meaning that almost 89% of indices were benchmarking no more than 2 funds.

70. Specifically, I classify as “index funds” all funds that are coded as index funds or as ETFs by Morningstar Direct. All other funds are classified as non-index funds.

71. The process for obtaining the prospectus data from EDGAR was as follows. First, I extracted a list of all the funds coded as index funds. I then searched for the fund by name on the EDGAR website and obtained the most recent prospectus. However, recognizing that the data was collected from Morningstar Direct in July 2017, and the searches on EDGAR were conducted in the middle of 2018, when there was a discrepancy between the index obtained using EDGAR and the index provided by Morningstar Direct, I repeated the search on EDGAR, and relied on the information as of December 31, 2017.

72. I was not able to find a methodology document for the index associated with one of these funds. As above, in this case, I relied on the description of the index in the prospectus.

73. This was the “Invesco QQQ Trust.”

index that is different from its *benchmark*, the index fund subsample is not a proper subset of full sample.

Table 3: Summary Statistics – Indices (Subsamples)

<i>Panel A: Non-Index Funds Only</i>								
	Mean	Standard Deviation	Percentile					Number of Indices
			10 th	25 th	50 th	75 th	90 th	
Number of Funds	26.37	90.2	1	1	2	6	74	87
Aggregate AUM (millions)	60,942	272,490	21	267	1,141	9,114	147,450	87
<i>Panel B: Index Funds Only</i>								
	Mean	Standard Deviation	Percentile					Number of Indices
			10 th	25 th	50 th	75 th	90 th	
Number of Funds	1.64	3.79	1	1	1	1	2	555
Aggregate AUM (millions)	7,971	74,585	4	33	233	1,399	8,006	555

This table presents the distribution of number of funds by index, as well as the aggregate AUM invested in funds (in millions of dollars) by index. Panel A presents this information within the non-index fund sample. In this sample, the index refers to the primary prospectus benchmark. The first column Panel A presents the average number of funds per index, as well as the average total AUM per index within the non-index fund sample. The second column of Panel A presents the standard deviations of the same. The third through seventh columns of Panel A present the 10th, 25th, 50th (i.e., the median), 75th, and 90th percentiles of the distributions. Panel B presents the same information within the index fund sample. In this sample, the index refers to the index that the fund tracks.

Table 3 shows that the skew is present in both subsamples. However, there are substantial differences between the two groups. Panel A shows that there are 87 different benchmark indices used by the 2,294 non-index funds in my sample, an average of about 26 funds per index. In contrast, the median number of funds per index is only 2, and even the 75th percentile index is the benchmark for only 6 mutual funds. Arguably, the most striking feature of this distribution is its skewness: the skewness of the number of funds is over 6.7, and the skewness of the AUM is over 7.8.

In contrast, the most striking feature of the results in Panel B is the relatively low number of funds per index across the board. The average number of funds per index is only 1.6 (with a median of 1), and even the 75th percentile in the first row is one, indicating that over 75% of indices are being tracked by a single index fund. These distributions are also highly skewed, with a skewness of about 14 and 18, respectively.

Table 4: Most Popular Indices (Subsamples)

<i>Panel A: Non-Index Funds Only</i>			
Index Name	Number of Funds	Index Name	Aggregate AUM (billion)
S&P 500	769	S&P 500	\$2,434
Russell 2000	198	Russell 1000 Value	\$542
Russell 1000 Value	182	Russell 1000 Growth	\$471
Russell 1000 Growth	176	Russell 2000	\$259
Russell 2000 Value	132	Russell Mid Cap Growth	\$193
Russell 2000 Growth	116	Russell Mid Cap Value	\$192
Russell Mid Cap Growth (<i>tied</i>)	80	Russell 2000 Value	\$170
Russell Mid Cap Value (<i>tied</i>)	80	Russell 3000	\$148
Russell 3000	74	Russell 1000	\$147
Russell 1000	73	Russell 3000 Growth	\$138
Russell 2500	52	Russell 2000 Growth	\$120
Russell 3000 Value (<i>tied</i>)	43	Russell 3000 Value	\$83
Russell Mid Cap (<i>tied</i>)	43	Russell Mid Cap	\$73
Russell 3000 Growth	40	Russell 2500	\$54
Russell 2500 Growth	30	Russell 2500 Growth	\$52
Russell 2500 Value (<i>tied</i>)	27	S&P MidCap 400	\$48
S&P MidCap 400 (<i>tied</i>)	27	NASDAQ Composite	\$21
Russell Micro Cap	14	Russell 2500 Value	\$19
S&P 1500	9	S&P 500 Utilities	\$16
S&P 500 Value (<i>tied</i>)	8	S&P 500 Growth	\$16
S&P SmallCap 600 (<i>tied</i>)	8		
Total number of funds	2,294	Total AUM	\$5,302
<i>Panel B: Index Funds Only</i>			
Index Name	Number of Funds	Index Name	Aggregate AUM (billion)
S&P 500	72	S&P 500	\$1,545
Russell 2000	35	CRSP U.S. Total Market	\$797
S&P MidCap 400	29	CRSP U.S. Mid Cap	\$110
NASDAQ 100	20	S&P MidCap 400	\$107
S&P SmallCap 600	15	CRSP U.S. Small Cap	\$97
DJ Industrial Average	12	CRSP U.S. Large Cap Growth	\$83
Russell 1000 Growth	7	NASDAQ 100	\$76
DJ U.S. Real Estate (<i>tied</i>)	6	S&P Completion	\$73
Russell 1000 (<i>tied</i>)	6	CRSP U.S. Large Cap Value	\$73
Russell 1000 Value (<i>tied</i>)	6	Russell 2000	\$69
Russell 3000 (<i>tied</i>)	6	DJ U.S. Total Stock Market	\$63
DJ U.S. Basic Materials (<i>tied</i>)	5	Russell 1000 Value	\$61
DJ U.S. Financial	5	Russell 1000 Growth	\$61
DJ U.S. Oil & Gas (<i>tied</i>)	5	S&P SmallCap 600	\$56
		NASDAQ U.S. Dividend	
NASDAQ Biotechnology (<i>tied</i>)	5	Achievers Select	\$39
Russell Mid Cap (<i>tied</i>)	5	Russell 3000	\$38
S&P 500 Growth (<i>tied</i>)	5	CRSP U.S. Small Cap Value	\$34
S&P 500 Value (<i>tied</i>)	5	S&P Financials Select Sector	\$32
S&P Oil & Gas Exploration & Production Select Industry (<i>tied</i>)	5	Russell 1000	\$31
S&P Regional Banks Select Industry (<i>tied</i>)	5	Russell Mid Cap	\$28
Total number of funds	911	Total AUM	\$4,424

This table presents the twenty most popular indices within the sample, as measured by the number of funds using the index (left panel) and the aggregate AUM (in billions of dollars) in the funds using the index (right panel). The last row of each panel presents the total numbers of funds and AUM associated with these twenty indices. Panel A presents this information within the non-index fund sample. In this sample, the index refers to the primary prospectus benchmark. Panel B presents the same information within the index fund sample. In this sample, the index refers to the index that the fund tracks.

Table 4 demonstrates that while there is substantial overlap between the dominant indices in both subsamples, that overlap is not complete. In particular, Panel A demonstrates the relative importance of growth and value indices (discussed in more detail below⁷⁴) among the non-index funds, as well as the dominance of Russell indices, which, after the S&P 500, make up the next 14 most popular indices by AUM and the next 15 most popular by number of funds. While these indices also make up a substantial portion of Panel B—the index fund sample—there is markedly more variety among these indices, even among only the twenty most popular indices. As discussed in more detail in the next two subsections, this level of variety is even more striking among the large number of smaller indices in my sample.⁷⁵

Interestingly, some of the indices in my sample, particularly those that are used by index funds, appear to have been created with the express purpose of being used for index investing. In other words, rather than creating an index fund based on a pre-existing index, in many cases, it was demand from prospective index fund creators that drove the creation of the underlying index.⁷⁶ While there is nothing inherently wrong with this, it puts further pressure on the traditional idea of an index fund as being qualitatively different from an actively managed fund.

B. Cataloguing the Methodology Documents

Before even considering the substance of the indices, the index methodology documents themselves demonstrate a striking amount of heterogeneity. Some are extremely long and detailed, sometimes cross-referencing several other documents. For example, the methodology document governing the Russell U.S. indices (including several of the indices—such as the Russell 2000—listed in Table 2 and Table 4) is 50 pages long and contains cross-references (complete with links) to 10 other documents.⁷⁷ The documents contain extremely detailed descriptions, including examples, of how the indices are

74. See *infra* Section II.C.3.a.

75. See *infra* Sections II.B and II.C.

76. Sometimes this is stated explicitly in the fund prospectus. For example, the December 22, 2017, summary prospectus for the “Deep Value ETF,” which tracks the “TWM Deep Value Index” notes that “The 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). Other times, it is implied by the description provided in the prospectus. For example, the Jan. 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).

77. FTSE RUSSELL, RUSSELL U.S. EQUITY INDEXES CONSTRUCTION AND METHODOLOGY v2.9 (Oct. 2017) (on file with author).

Robertson

constructed. While a modest amount of ambiguity remains in certain respects,⁷⁸ overall the amount of detail is impressive.

At the other end of the spectrum, some of the methodology documents are only a couple of pages long and provide almost no detail at all. For example, the “NASDAQ U.S. Dividend Achievers Select Index Methodology” (which appears in Panel B of Table 4) is less than 3 pages long, almost a page of which is taken up by a listing of the eight different versions of the index. The discussion of the eligibility criteria contains less than 40 words, and is reproduced in its entirety below⁷⁹:

Eligibility Criteria

To be eligible for inclusion in the Index a security must meet the following criteria:

- be included in the NASDAQ US Broad Dividend Achievers™ Index (DAA) excluding limited partnerships and REITs; and
- additional proprietary eligibility are applied.

Despite this less than voluminous description, the index is being used as an underlying index for funds with about \$39 billion in aggregate AUM.

The NASDAQ U.S. Dividend Achievers Select Index is not the only one to contain a reference to another index: I found that many indices did so. For example, it was common for one index to use the constituents of another index as a starting point. Perhaps unsurprisingly, this was particularly common within an index family. So, for example, several S&P indices referred back to the constituents of the S&P 500 as a starting point,⁸⁰ and several members of the Russell family referred to the Russell 3000, 2000 or 1000.⁸¹ Perhaps more surprising are the indices that refer to the constituents of another index that *not* a member of the same index family. For example, each of the six Oppenheimer

78. Discussed *infra* Section II.D.

79. NASDAQ, NASDAQ U.S. DIVIDEND ACHIEVERS SELECT INDEX METHODOLOGY (Apr. 2017) (on file with author).

80. Examples include the S&P 500 Momentum Index, S&P DOW JONES INDICES, S&P MOMENTUM INDICES METHODOLOGY (July 2017) (on file with author); S&P 500 Dividend Aristocrats Index, S&P DOW JONES INDICES, S&P 500 DIVIDEND ARISTOCRATS METHODOLOGY (Feb. 2017) (on file with author), and the S&P 500 Catholic Values Index, see S&P DOW JONES INDICES, S&P 500 CATHOLIC VALUES INDEX METHODOLOGY (July 2017) (on file with author).

81. FTSE RUSSELL, *supra* note 77. In fact, the Russell 2000 and 1000 are themselves subsets of the Russell 3000. See also the Russell “Pure Style,” where the methodology refers back to the “parent” indices. FTSE RUSSELL, RUSSELL PURE STYLE INDEX SERIES v2.1 (Aug. 2017) (on file with author).

indices in my sample use an S&P index as its starting point.⁸² This is despite the fact that Oppenheimer does not appear to have any formal affiliation with S&P.⁸³

To more systematically investigate the heterogeneity across indices, I coded all the indices in my sample for a variety of factors. These factors are primarily intended to help to categorize the indices according to how they may be used, or perceived, by market participants. In other words, this classification is intended to capture what the index purports to be, according to its methodology document. These characteristics are summarized in Table 5 for the full sample, and by index and non-index funds in Table 6.⁸⁴

First, I coded whether or not an index is an “industry” or “sector” index, in the sense that its constituents are restricted to a particular industry or sector. Surprisingly, 232 of the 601 indices—nearly 40%—satisfied this criterion, despite the fact that only 345 of the funds (representing a total AUM of over \$400B) benchmarked to these indices. I also identified a further 21 indices (corresponding to 21 funds, and a total AUM of over \$3B) that I call “exclusive industry indices”—rather than focusing on a particular industry or sector, these indices *exclude* securities from a particular industry.

Next, I coded the indices for size, including mega, large, medium, small, and micro-cap, as well as broad indices and combinations of sizes (such as large- and medium-cap, or medium- and small-cap). Broad indices were the most common, followed by large cap (261 and 186 indices, respectively). Interestingly, while these two size categories also represented a large number of funds (562 and 1,560, respectively), proportionately, there was a larger number

82. Specifically, three use the S&P 500 Index. *See* OFI Revenue Weighted ESG Index, OFI REVENUE WEIGHTED ESG INDEX, OPPENHEIMERFUNDS 2 (Oct. 2017) (on file with author); OFI Revenue Weighted Financials Sector Index, OFI Revenue Weighted Financials Sector Index, OPPENHEIMERFUNDS 2 (Oct. 2017) (on file with author); OFI Revenue Weighted Large Cap Index, OFI REVENUE WEIGHTED LARGE CAP INDEX, OPPENHEIMERFUNDS 2 (Oct. 2017) (on file with author). One uses the S&P MidCap 400 Index (the OFI Revenue Weighted Mid Cap Index), one uses the S&P SmallCap 600 Index (the OFI Revenue Weighted Small Cap Index), and one uses the S&P 900 (the OFI Revenue Weighted Ultra Dividend Index), which is itself composed of the constituents of the S&P 500 and the S&P MidCap 400. *See* S&P DOW JONES INDICES, *supra* note 41, at 3.

83. I also note that the relationship between *index* families and *fund* families is complex. It is not uncommon for index funds from different fund families to track indices provided by the same index family. The most obvious examples of these would be the plethora of funds that track members of the S&P and Russell index families. Perhaps more surprisingly, different index funds within the *same* fund family sometimes track indices created by *different* index families. To choose just one example, while several of the funds in my sample issued by the Fidelity Salem Street Trust track indices that are part of the Russell family, a few track MSCI indices. For example, according to its December 2017 prospectus documents, the Fidelity SAI U.S. Minimum Volatility Index Fund tracked the MSCI USA Minimum Volatility Index. FIDELITY SAI U.S. MINIMUM VOLATILITY INDEX FUND, SUMMARY PROSPECTUS (Form N-1A) (Dec. 30, 2017). This is the case even though there is a low volatility index within the Russell family: the Russell 1000 Low Volatility Focused Factor Index. This second index was, during this time, tracked by a different fund—the SPDR Russell 1000 Low Volatility Focus ETF. SPDR RUSSELL 1000 LOW VOLATILITY FOCUS ETF, SUMMARY Prospectus (Form N-1A) 11 (Oct. 27, 2017). There could be several reasons for this phenomenon, including competition within the industry.

84. While I made every effort to code the documents as consistently as possible, I recognize that any attempt to classify these indices is likely to be somewhat subjective. This risk is exacerbated by the fact that, as discussed, there is very little consistency across methodology documents.

Robertson

of medium size funds (968) than there were indices (97), indicating that on average, the medium sized indices are begin used as benchmarks for more funds. Roughly the same amount of money was benchmarked to both broad and medium-sized indices (\$1.9 trillion and \$1.7 trillion, respectively), while substantially more was benchmarked against large indices (\$5.8 trillion), chiefly because of the importance of the S&P 500 (representing about \$4 trillion of that).

Table 5: Index Characteristics (Full Sample)

Characteristic		Number of Indices	Number of Funds	Aggregate AUM (billion)
Industry	Industry Index	232	345	\$413
	Exclusive Industry	21	21	\$3
Size*	Broad	261	562	\$1,860
	Mega	12	16	\$14
	Large	186	1560	\$5,849
	Medium	97	968	\$1,735
	Small	61	100	\$381
	Micro	8	30	\$6
	Other	11	11	\$7
Style	Value/Growth	179	1,152	\$2,594
	Dividend	61	71	\$169
	Beta	11	11	\$4
	Momentum	87	89	\$27
	Earnings	62	67	\$43
	Size	32	34	\$6
	Volatility	53	61	\$49
	Quality	86	89	\$40
At Least One	310	1,300	\$2,812	
Specialized	Specialized Index	178	191	\$130
	Proprietary Index	87	88	\$82
Total		601	3,206	\$9,726

This table summarizes the characteristics of the indices in the sample. The first column presents the number of indices coded as having the relevant characteristic. The second presents the total number of funds associated with these indices, and the third presents the aggregate AUM (in billions of dollars) invested in those funds. Note that many of these characteristics are overlapping. For example, an index may be both a value index and an industry-specific index, or a large-cap dividend index.

*Some indices were intended to capture more than one size segment (for example, small and medium). While these were coded separately, for the purposes of this table, they are included in all of the relevant size segments. As a result, the figures in this table may not correspond to those in the text.

I also coded indices for “style,” something that I borrow from the mutual fund and hedge fund literature. A style represents a particular investment strategy. Balancing parsimony with granularity, I focus on eight such styles: value/growth, momentum, size, beta, dividends, volatility, earnings, and

“quality.” The first four represent the four most prominent asset pricing factors, while the fifth one appears to be related to one of the more recently added pricing factors.⁸⁵ I included the remaining three for two reasons. First, in my initial review of the methodology documents, they were quite common, leading me to suspect that they might be popular across the indices more broadly. This suspicion appears to be borne out by the data, as Table 5 makes clear. Second, while there is no clear theoretical reason why investors should care about these three factors, they all have a sufficiently clear and uncontroversial meaning that I felt that they could be coded consistently. I discuss each style in more detail in the next Section.

In the full sample, by far the most popular of these styles was value/growth, representing 179 indices, which were associated with 1,152 funds (with a total AUM of about \$2.6 trillion). This disproportionate popularity exists in both subsamples, albeit in slightly different ways: In the non-index subsample, where 21 indices (almost a quarter of the indices in the subsample) representing 936 funds (over 40%) and over \$2 trillion of AUM (38% of the total). In the index fund subsample, value/growth indices make up an even large fraction of the number of indices (over 30%), but they make up a somewhat smaller fraction of the number of funds and AUM (24% and 13%, respectively). The other styles were less popular, and each was associated with between 11 and 87 indices (between 11 and 89 funds, and about \$4 billion and \$170 billion of AUM). There was substantial overlap between styles—for example, I coded 50 indices as both value/growth and momentum, corresponding to 51 funds and an aggregate AUM of over \$17 billion. In total, I found that 310 indices purported to correspond to at least one of the eight styles, representing 1,300 funds and a little over \$2.8 trillion.

In general, I make no judgement as to whether or not an index is a “good” style index. For example, if an index purports to be a growth index, I do not pass judgment as to whether or not its methodology is likely to capture the “growth” factor as it is commonly understood in the finance literature. However, I do include indices that purport to use standard value/growth proxies—such as price/book ratios—in this category.

Finally, I recorded information about “specialized” or “bespoke” indices. These include indices that rely on a confidential or proprietary methodology, as well as those that employ a highly specialized strategy. I coded 178 indices as “specialized” in some way, which corresponded to 191 funds (for a total AUM of \$130 billion). While the overwhelming majority of these specialized indices are being used by index funds, nine are being used to benchmark non-index funds.

85. See discussion *infra* Section II.C.3 for more detail.

Table 6: Index Characteristics

	Characteristic	<i>Non-Index Funds Only</i>			<i>Index Funds Only</i>		
		Number of Indices	Number of Funds	Aggregate AUM (billion)	Number of Indices	Number of Funds	Aggregate AUM (billion)
Industry	Industry Index	30	48	\$49	210	297	\$364
	Exclusive Industry	0	--	--	21	21	\$3
Size*	Broad	34	215	\$428	242	348	\$1,432
	Mega	1	1	<\$1	12	15	\$14
	Large	23	1,243	\$3,652	174	315	\$2,195
	Medium	15	791	\$1,190	93	176	\$545
	Small	7	16	\$29	58	85	\$352
	Micro	5	26	\$5	4	4	\$1
	Other	3	3	\$6	8	8	\$1
Style	Value/Growth	21	936	\$2,016	169	215	\$578
	Dividend	4	5	\$7	60	66	\$162
	Beta	0	--	--	11	11	\$4
	Momentum	1	1	\$5	86	88	\$21
	Earnings	3	3	\$1	60	64	\$42
	Size	0	--	--	32	34	\$6
	Volatility	4	4	\$1	51	57	\$48
	Quality	2	2	\$1	84	87	\$39
At least One	28	944	\$2,024	297	355	\$789	
Specialized	Specialized Index	9	9	\$6	174	183	\$125
	Proprietary Index	1	1	<\$1	87	87	\$82
Total		87	2,294	\$5,302	555	911	\$4,424

This table summarizes the characteristics of the indices in the sample. The first column presents the number of indices coded as having the relevant characteristic. The second presents the total number of funds associated with these indices, and the third presents the aggregate AUM (in billions of dollars) invested in those funds. Note that many of these characteristics are overlapping. For example, an index may be both a value index and an industry-specific index, or a large-cap dividend index. Panel A presents this information within the non-index fund sample. In this sample, the index refers to the primary prospectus benchmark. Panel B presents the same information within the index fund sample. In this sample, the index refers to the index that the fund tracks.

*Some indices were intended to capture more than one size segment (for example, small and medium). While these were coded separately, for the purposes of this table, they are included in all of the relevant size segments. As a result, the figures in this table may not correspond to those in the text.

In addition to recording these index types, I read each methodology document with an eye towards recording their material characteristics. In particular, I was interested in aspects of the methodologies that made it hard for a third party to replicate the index based on publicly available data. I discuss this in more detail below in Section II.D.

C. Index Heterogeneity

The differences in the presentation of the methodology documents, while substantial, is just the tip of the iceberg. My investigation of the methodology documents uncovered enormous heterogeneity even within indices that are designed to capture the same fundamentals. For the purposes of this discussion,

I consider all indices in my sample: those that are used by index funds, as well as those used by non-index funds.

1. Industry

One domain in which one might expect to find relatively little heterogeneity is in the classification of industries for the purpose of creating industry indices. While it is no doubt the case that some firms straddle multiple industries, this problem arises under any classification scheme. In the United States, SIC codes, which have since been supplanted by NAICS codes, already exist for this purpose. SIC codes and NAICS codes are routinely used by both academic researchers and governmental agencies to classify firms.⁸⁶

Interestingly, despite the dominance of SIC and NAICS codes in other areas, most industry indices do not rely on these classification schemes. Instead many rely on proprietary sector or industry classifications, and there is no consistent definition across index providers. For example, consider the retail sector. It turns out that NASDAQ, NYSE, MVIS, and S&P each have an index of the U.S. retail market.⁸⁷ Surprisingly, each of these indices appears to rely on a different classification method—the NASDAQ index relies on “ICB Codes,”⁸⁸ the NYSE index uses an “NYSE proprietary screening,”⁸⁹ the S&P index uses the “Global Industry Classification Standard (GICS),”⁹⁰ and the MVIS is silent as to its classification methodology.⁹¹ With the exception of the MVIS classification scheme, which I cannot observe at all, each of these classification schemes is proprietary. The upshot of this is that, not only could the definition of, for example, “retail,” differ across indices, it is difficult to predict *how* this definition might vary.

2. Size

There is also substantial disagreement about the definitions of size across indices. For example, within the Russell family, the large-cap index is the Russell 1000, which captures the 1000 largest stocks, while the S&P’s large-cap index—

86. See generally Executive Office of the President, *North American Industry Classification System*, OFF. OF MGMT. AND BUDGET 3 (2017), https://www.census.gov/eos/www/naics/2017NAICS/2017_NAICS_Manual.pdf [<https://perma.cc/MZX9-PTD9>].

87. These are the NASDAQ U.S. Smart Retail Index, the Dynamic Retail Intellidex Index, the MVIS U.S. Listed Retail Index, and the S&P Retail Select Industry Index, respectively.

88. NASDAQ, NASDAQ U.S. SMART SECTOR INDEX FAMILY METHODOLOGY (July 2016) (on file with author).

89. NYSE ARCA, INTELLIDEX METHODOLOGY, VERSION 2.0 (Aug. 2016) (on file with author).

90. S&P DOW JONES INDICES, S&P SELECT INDUSTRY INDICES METHODOLOGY (Sept. 2016) (on file with author).

91. MVIS, INDEX GUIDE, MVIS GLOBAL EQUITY INDICES, VERSION 5.61 (Sept. 2017) (on file with author).

Robertson

the S&P 500 index—uses 500 stocks. As of May 31, 2018, the total market cap of the median security on the S&P 500 was \$20.6 billion,⁹² compared to a much more modest \$10.6 billion on the Russell 1000.⁹³ The same is true with respect to medium- and small-cap stocks. On the same date, the total market cap of the median constituent on the S&P’s mid-cap index—the S&P MidCap 400—was \$4.3 billion,⁹⁴ compared to \$8.2 billion for the Russell Midcap Index.⁹⁵ In the small-cap space, these figures were \$1.3 billion for the S&P SmallCap 600,⁹⁶ and \$0.9 billion for Russell’s small-cap index, the Russell 2000.⁹⁷ While I made every effort to code consistently, I recognize that my coding will inevitably be a rough proxy.

An even bigger issue arises in the context of “broad” indices. Rather than attempting to act as the arbiter of what constitutes a sufficiently broad swath of the equity market, I classify any index that does not specifically target a size segment as a “broad” index. Nevertheless, I note that I found very different size thresholds among the indices I classified as “broad.”

3. Style

There was even more heterogeneity across the style indices. Even at a fairly basic level, different indices approached the problem of how to create a style tilt in different ways. For example, some indices generated their desired style tilt entirely through weighting: while all securities in the consideration set were included, they were weighted according to the index’s style score. Others chose to retain a more standard weighting scheme (such as value weighting), while selecting securities based on a style score. Naturally, some do both.⁹⁸

a) Value/Growth

As discussed above, the most popular style among the eight I coded for, by any metric, was value/growth. This is not particularly surprising: the value anomaly is among the most robust and well-known asset pricing anomalies.⁹⁹

92. S&P DOW JONES INDICES, *supra* note 41, at 1.
93. FTSE RUSSELL, RUSSELL 1000 INDEX FACTSHEET 1 (May 31, 2018) (on file with author).
94. S&P DOW JONES INDICES, S&P MIDCAP 400 FACTSHEET 1 (May 31, 2018) (on file with author).
95. FTSE RUSSELL, RUSSELL MIDCAP INDEX FACTSHEET 1 (May 31, 2018) (on file with author).
96. S&P DOW JONES INDICES, S&P SMALLCAP 600 FACTSHEET 1 (May 31, 2018) (on file with author).
97. FTSE RUSSELL, RUSSELL 2000 INDEX FACTSHEET 1 (May 31, 2018) (on file with author).
98. One example of this is the S&P Low Volatility family of indices, which includes the S&P 500 Low Volatility Index. S&P DOW JONES INDICES, S&P LOW VOLATILITY INDICES METHODOLOGY (Aug. 2017) (on file with author).
99. Clifford S. Asness, Tobias J. Moskowitz & Lasse Heje Pedersen, *Value and Momentum Everywhere*, 68 J. FIN. 929 (2013).

Since it was made famous by Fama and French in their 1993 article,¹⁰⁰ it has become a staple of both academics¹⁰¹ and investors. For example, a large-scale representative study of U.S. individuals conducted in December 2016 found that 58% of Americans expected value stocks to have different level of risk from that of growth stocks, and 53% expected them to have different returns going forward.¹⁰² In the academic finance literature, a “value” stock is generally defined as a stock with a relatively high book-to-market ratio. In other words, these are the stocks of companies that have a market capitalization that is relatively low compared to the accounting value of the company’s assets. Conversely, a growth stock is generally defined as a stock with a relatively low book-to-market ratio. These are the stocks of companies that have a market capitalization that is relatively high compared to the accounting value of the company’s assets.¹⁰³

Because value and growth are two sides of the same conceptual coin, I coded them into the same category. In order to ensure that I did not miss any indices that used different terminology, I also included those that described themselves as relying on price-to-book variables. Even allowing for this, there was a tremendous amount of heterogeneity across the different indices in this category. Despite the fact that there is a standard definition of value/growth in the academic literature, there is substantial heterogeneity in the way that the scores are computed across indices.

For example, the StrataQuant family of indices, which includes 9 indices benchmarking an aggregate total of over \$8.7 billion in AUM, scores eligible securities based on what is calls “value” and “growth” factors.¹⁰⁴ One of the value factors—price-to-book value—follows the standard definition of the value, and a second—price-to-cash flow—is at least consistent with the idea of comparing price to some fundamental. The third and final value factor—return on assets—is more puzzling and appears to be capturing something distinct from the traditional definition of value. Even more perplexing are the “growth” factors. Theoretically, growth is simply the other end of value—rather than being separate concepts, a security with a very low value score could simply be interpreted as a growth stock. This is not what StrataQuant does. Instead, it defines five different growth factors: 3-, 6- and 12-month price appreciation,

100. Eugene F. Fama & Kenneth R. French, *Common Risk Factors in the Returns on Stocks and Bonds*, 33 J. FIN ECON. 3 (1993).

101. Sebastien Betermier, Laurent E. Calvet & Paolo Sodini, *Who Are the Value and Growth Investors?*, 72 J. FIN. 5 (2017).

102. James J. Choi & Adriana Z. Robertson, *What Matters to Individual Investors? Evidence from the Horse’s Mouth* 57 tbl.15 (NBER Working Paper No. 25019, 2018), <https://www.nber.org/papers/w25019.pdf> [<https://perma.cc/C9WJ-XQXB>].

103. The term growth follows from this low book-to-market ratio, since this low ratio can be interpreted as implying that the market expects the price to rise relatively quickly, thereby bringing this ratio up towards the median.

104. NYSE, STRATAQUANT INDEX FAMILY VERSION 2.2 (Sept. 2015) (on file with author).

Robertson

price-to-sales ratio, and 1-year sales growth. The first three are likely to be capturing momentum rather than the traditional “growth” factor, and the fourth is likely to be highly correlated with the price to cash flow measure used as a value factor. Conceptually, the fifth factor appears to be some hybrid of the other four. There is nothing necessarily wrong with selecting stocks based on these criteria; as discussed in the next subsection, momentum is a highly robust factor. The point is simply that many of these factors are capturing something quite different from the standard value/growth factors.

StrataQuant is hardly unique in this regard. For example, the Intellidex methodology, used by, *inter alia*, the Dynamic Large Cap Value Intellidex, also constructs separate value and growth factors based on different metrics.¹⁰⁵ In the case of Intellidex, these metrics are (1) price/forecasted earnings, (2) price/book, (3) price/sales, (4) price/cash flow, and (5) dividend yield for the value factor, and (1) long-term projected earnings growth, (2) earnings growth, (3) sales growth, (4) cash flow growth, and (5) book value growth for the growth factor. Again, only some of these metrics align with the traditional understanding of growth and value in the finance literature.

While this general pattern holds across a wide variety of the indices I examined, one outlier stands out. The Morningstar U.S. Market Factor Tilt Index simply uses the Fama-French 1993 factors.¹⁰⁶ As a result, this is likely to be far closer to the traditional definition of “value.”

b) Momentum

The second most popular style, at least in terms of number of indices or funds, was momentum. Interestingly, despite the fact that momentum rivals value in terms of robustness as an asset pricing anomaly,¹⁰⁷ a far smaller dollar amount (about \$27 billion) was associated with these indices.

As with value and growth, in order to ensure that the measure was not underinclusive, I included certain indices that did not explicitly refer to themselves as capturing “momentum,” as long as they described themselves as relying on the path of historical returns.¹⁰⁸ Because momentum is best measured by observing the path of past returns, including these indices allows me to more consistently capture the same conceptual style. Of course, one consequence of this is that I am also capturing things that we would not traditionally call momentum strategies, such as so-called “technical analysis” investing

105. NYSE ARCA, *supra* note 89.

106. MORNINGSTAR, CONSTRUCTION RULES FOR THE MORNINGSTAR U.S. MARKET FACTOR TILT INDEX (Dec. 2015) (on file with author).

107. Asness et al., *supra* note 99, at 930.

108. I did not include indices that used something like price appreciation in constructing what they called a value or growth factor. As a result, for example, the StrataQuant indices would not be included.

strategies.¹⁰⁹ As such, even the relatively small dollar value associated with this category likely overstates the prominence of true momentum indices.

While there was somewhat less heterogeneity among the momentum indices, they were far from consistent. For example, rather than simply using 6- or 12-month returns, the MSCI U.S.A. Momentum Index normalizes each of these two measures by the “annualized Standard Deviation of weekly local price returns over the period of 3 years.”¹¹⁰ It then standardizes each of these two measures¹¹¹ and averages them to compute a security-level score. Other indices are harder to evaluate because of a lack of specificity in the methodology document. For example, the Dorsey Wright Technical Leaders Index document states only that eligible securities “are ranked using a proprietary relative strength (momentum) measure. Each security’s score is based on intermediate and long-term price movements relative to a representative market benchmark.”¹¹²

c) Dividends

Another very popular style related to dividends. As measured by aggregate AUM, this was the second most popular style. From a theoretical level, this is somewhat puzzling. Financial economists have long questioned the economic value of dividends.¹¹³ While some explanations for the phenomenon (both rational and behavioral) exist,¹¹⁴ it is not clear that they would predict that about \$170 billion be benchmarked to dividend-related indices, particularly in light of

109. Technical analysis is an investment strategy that involves analyzing past price patterns to forecast future returns. *See, e.g.*, Lee Bohl & Randy Fredrick, *How to Pick Stocks Using Fundamental & Technical Analysis*, CHARLES SCHWAB, <https://www.schwab.com/active-trader/insights/content/stock-selection-using-fundamental-technical-analysis> [<https://perma.cc/D9NU-Q5YY>] (“[T]echnical analysis . . . focuses on patterns within stock charts as a way to try to forecast future pricing and volume trends.”)

110. MSCI, MSCI MOMENTUM INDEXES METHODOLOGY 4-5 (June 2017) (on file with author).

111. Standardizing consists of subtracting the mean and dividing by the standard deviation. The values are then winsorized at +/- 3. *Id.* at 5.

112. NASDAQ, DORSEY WRIGHT TECHNICAL LEADERS INDEX FAMILY METHODOLOGY 4 (Apr. 2017) (on file with author).

113. *See, e.g.*, Laurie Simon Bagwell & John B. Shoven, *Cash Distributions to Shareholders*, 3 J. ECON. PERSPECTIVES 129 (1989) (noting that “[e]conomists have long been puzzled by why firms pay dividends”); H. Kent Baker & Gary E. Powell, *How Corporate Managers View Dividend Policy*, 38 Q.J. BUS. & ECON. 17 (1999) (noting that “[d]ividend policy is one of the most controversial subjects in finance”); H. Kent Baker, Gary E. Powell & E. Theodore Veit, *Revisiting the Dividend Puzzle*, 11 REV. FIN. ECON. 241 (2002) [hereinafter Baker et al., *Revisiting*] (noting that “[d]espite exhaustive theoretical and empirical analysis to explain their pervasive presence, dividends remain one of the thorniest puzzles in corporate finance”).

114. *See* Baker et al., *Revisiting*, *supra* note 113 (surveying various explanations that have been proposed). Of course, despite the fact that financial economists find dividends puzzling, it remains possible that, for whatever reason, investors *want* to invest in mutual funds that contain dividend paying stocks. In that case, the popularity of dividend indices could simply reflect this demand by investors. For example, some investors might like to receive regular cash payments from their mutual fund investments, but they might not want to invest in bond funds or to regularly liquidate some proportion of their investment.

the fact that less than 1/6 of this value is benchmarked to momentum, something that is unambiguously associated with returns.

While the heterogeneity is, perhaps unsurprisingly, less extreme in this context, the indices are still not entirely consistent. For example, indices rely on different horizons of past dividend payments. Whereas the Wisdom Tree Indices use the past 12 months,¹¹⁵ some of the NASDAQ indices use the past 10 years.¹¹⁶

d) Volatility

Like dividends, the existence of indices relating to volatility is something of a puzzle. As a general matter, finance theory teaches that an asset's (or a portfolio's) volatility—i.e., variance—should not, on its own, be relevant to investors. Instead, what ought to matter is how well that asset (or portfolio) does when the investor really needs the money. If asset A has a high volatility but tends to do well at times when an investor really needs the money, we would expect her to prefer it to asset B, which has a relatively low volatility but tends to do poorly when she really needs the money.¹¹⁷ While this statement seems accurate, there may be instances in which investors do care about volatility *per se*. For example, Moreira and Muir argue that portfolios that scale monthly returns by the inverse of their previous month's variance can, among other things, be attractive to certain types of investors.¹¹⁸

While volatility is among the most standard measures in finance, even here there was substantial heterogeneity. Some indices took a fairly standard approach. For example, the S&P low volatility indices—S&P 500 Low Volatility Index, the S&P MidCap 400 Low Volatility Index, and the S&P SmallCap 600 Low Volatility Index—select a predetermined number of stocks from the appropriate parent index based on realized volatility over the past year.¹¹⁹ These securities are then weighted by the reciprocal of this volatility measure, so that the least volatile securities receive the most weight.

In addition to “low” volatility indices there are also so-called “minimum volatility” indices. These indices seek to minimize the volatility of the index portfolio, subject to certain constraints. These tend to rely on proprietary “optimizers,” making their construction relatively opaque. Two examples of such indices are the S&P 500 Minimum Volatility Index and the MSCI U.S.A.

115. WISDOMTREE, WISDOMTREE RULES-BASED METHODOLOGY, DOMESTIC AND INTERNATIONAL DIVIDEND INDEXES 3 (June 2017) (on file with author).

116. Two examples of this are the *NASDAQ U.S. Broad Dividend Achievers Index*, NASDAQ U.S. BROAD DIVIDEND ACHIEVERS INDEX METHODOLOGY 2 (Nov. 2013) (on file with author) and the *NASDAQ U.S. Dividend Achievers Select Index*, *supra* note 79, at 2.

117. Choi and Robertson find that a “[c]oncern that when I especially need the money, the stock market will tend to drop” a very or extremely important factor for over 35% of individuals and is at least a moderately important factor for almost 61%. Choi & Robertson, *supra* note 102, at 42 tbl.1.

118. Alan Moreira & Tyler Muir, *Volatility-Managed Portfolios*, 72 J. FIN. 1611 (2017).

119. S&P LOW VOLATILITY INDICES METHODOLOGY, *supra* note 98.

Minimum Volatility Index. The former relies on the “Northfield Open Optimizer,”¹²⁰ and the latter relies on the “Barra Optimizer.”¹²¹

e) Earnings and “Quality”

Indices related to earnings were also fairly popular, at least measured in terms of aggregate AUM. Included in the group are indices that purport to capture factors related to revenue, sales, operating cash flows, as well as earnings generally.

Perhaps related to earnings was a somewhat amorphous factor generally described as “quality.” Unfortunately, quality is not a term that is commonly used in the finance literature, and it lacks a precise definition. Based on my reading of the methodology documents, it appears to capture some combination of revenue growth and/or stability, profitability, levels of cash on hand, and debt ratios. As such, I include indices that refer to these features. Because quality and earnings can both relate to revenue, there is some overlap between the two groups. Nevertheless, it is clear that quality is intended to capture more than just earnings, and it is possible that in some cases it may be related to the profitability factor in the Fama-French five-factor model.¹²²

Given the fact that quality is fairly amorphous, it is perhaps unsurprising that there is a substantial amount of heterogeneity in the way these indices are constructed. For example, for the purposes of the MSCI U.S.A. Quality Index, quality was measured by a combination of (1) return on equity (trailing twelve-month earnings per share divided by latest book value per share), (2) debt-to-equity ratio (total debt divided by book value in the last fiscal year), and (3) earnings variability (the standard deviation of year-over-year earnings growth per share over the last five years).¹²³ In contrast, the S&P 500 quality indices, including the S&P 500 Quality Index, measure quality through a combination of (1) accruals ratio, (2) financial leverage ratio, and (3) return on equity.¹²⁴ While there is some overlap between these metrics, they are clearly distinct. Even more distinct is the definition employed by Northern Trust in its indices.¹²⁵ While its scoring model is proprietary, according to the methodology, its three “core components” are “Management Expertise (e.g., corporate finance activities),

120. S&P DOW JONES INDICES, S&P MINIMUM VOLATILITY INDEX METHODOLOGY (July 2017) (on file with author).

121. *MSCI Minimum Volatility Index Methodology*, MSCI (Sept. 2017) (on file with author).

122. Eugene F. Fama & Kenneth R. French, *A Five-Factor Asset Pricing Model*, 116 J. FIN ECON. 1 (2015).

123. MSCI QUALITY INDEXES METHODOLOGY, MSCI 9 (June 2017) (on file with author).

124. *S&P Quality Indices Methodology*, S&P DOW JONES INDICES 16 (July 2017) (on file with author).

125. These include the Northern Trust Quality Large Cap Index, the Northern Trust Quality Dividend Index, the Northern Trust Quality Dividend Defensive Index, and the Northern Trust Quality Dynamic Index. The aggregate AUM benchmarked to these four indices is almost \$2.8 billion.

Robertson

Profitability (e.g., assess the reliability and the sustainability of financial performance), and Cash Flow.”¹²⁶

f) Size and Beta

Along with value/growth, the other two factors in the classic Fama-French asset-pricing model are size and “market beta.” These two factors, however, were far less popular along all three dimensions (number of indices, number of funds, and aggregate AUM), and were seventh and eighth out of eight, respectively. The fact that size is relatively unpopular is not particularly surprising from a theoretical perspective. While there has historically been a “size” premium—smaller companies were associated with higher returns—there is some question as to whether this premium still exists.¹²⁷ Another possibility is that indices that focus on particular size *segments* could be acting as substitutes for indices that focus on a size as a style factor.

The fact that “beta” is relatively unpopular is more interesting. In principle, an asset’s “beta” captures the component of that risk associated with that asset that is priced. In other words, the only way for asset A to have systematically higher returns than asset B is if asset A has a higher beta.¹²⁸ In most practical applications, beta is computed with reference of some proxy for “the market.” As such, investors might find it useful to have access to an index that is designed to have a particular level of market risk. On the other hand, there is also evidence that high beta assets (not portfolios) tend to underperform, something that has been attributed to the fact that individual investors have difficulty taking leveraged positions.¹²⁹ Another possibility is that investors have less need for indices designed around any particular beta, since one can always construct one from the return on any index with a known beta. Finally, it may be that, compared to other style factors, beta is less well known among the investing public, depressing demand for such indices.

4. “Specialized” or “Bespoke” Indices

Finally, there are what I term the “bespoke” or “specialized” indices. In this category, I also include indices that rely on proprietary methodologies, since there is no way of determining how they are constructed. These are generally used by only one or two funds and tend to have far less AUM benchmarked

126. *Northern Trust Quality Dividend Index Methodology*, NORTHERN TRUST 4 (on file with author); *Northern Trust Quality Large Cap Index Methodology*, NORTHERN TRUST 3 (on file with author).

127. See Mathijs A. Van Dijk, *Is Size Dead? A Review of the Size Effect in Equity Returns*, 35 J. BANKING & FIN 3263 (2011).

128. See, e.g., RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, *PRINCIPALS OF CORPORATE FINANCE* 881 (11 ed. 2014).

129. Andrea Frazzini & Lasse Heje Pedersen, *Betting Against Beta*, 111 J. FIN. ECON. 1 (2014).

against them. However, while the values tend to be small on average, they add up. In total, the 171 indices I coded as “specialized” act as benchmarks for \$130 billion in AUM. Unsurprisingly, there is an enormous amount of variety across these indices. Some of these are clearly designed to appeal to certain groups of investors, such as the “S&P 500 Catholic Values Index,” the “Barclays Women in Leadership Index,” or the “SSGA Gender Diversity Index.” Others are included because they focus on a particular niche, such as the “Solactive Guru Index,” the “iBillionaire Index,” or the “WeatherStorm Forensic Account Long-Short Index.” Still others are aimed at “responsible” investing. A final group of indices is included in this category primarily because they are constructed using proprietary methodologies, making them virtually impenetrable to outsiders.

D. Transparency Versus Opacity

The discussion in the prior Section also revealed another dimension of heterogeneity: the substantial variation in the amount of detail provided by the indices. This heterogeneity manifested itself in very different ways, including the selection criteria used by the index, the degree to which the underlying data required to construct the index were publicly available, and the description of an applicable governance or oversight body. Even *within* these categories, the amount of detail, or lack thereof, varied substantially across indices, and often even *within* index families. In this Section, I briefly address this issue.

1. Selection Criteria

We have already seen that the selection criteria varied substantially across indices. Perhaps more surprisingly, however, was the degree to which the amount of information provided about these selection criteria varied across indices. Some indices provided a detailed discussion of the selection criteria. For example, the methodology employed in constructing the CRSP family of indices—including the CRSP U.S. Total market Index—is extensively documented, including extensive formulas, variable descriptions, and even figures.¹³⁰

Others, in contrast, were far more circumspect. For example, the Dow Jones Industrial Average—another prominent index—selects constituents from a universe consisting of the securities on the S&P 500 using a selection process not based on quantitative criteria.¹³¹ Instead, “a stock typically is added only if the company has an excellent reputation, demonstrates sustained growth and is of interest to a large number of investors.”¹³² Similarly, the eighty-four indices

130. *CRSP U.S. Equity Indexes Methodology Guide*, CRSP CENTER FOR RESEARCH IN SECURITY PRICES (Dec. 2016) (on file with author).

131. DOW JONES AVERAGES METHODOLOGY, *supra* note 47, at 5.

132. *Id.*

employing “proprietary” methodologies are necessarily opaque to outsiders not privy to those proprietary methodologies.

Other indices use selection criteria that are hard to replicate for other reasons. For example, while the “economic moat”¹³³ rating employed by Morningstar is described in great detail in the “Morningstar Equity Research Methodology” document,¹³⁴ it relies in large part on assessments made by analysts, and which cannot be easily replicated by following the description in the documentation. By contrast, as discussed above, the Russell 1000 and 2000 indices are constructed using fairly clear cutoff rules.¹³⁵

2. Underlying Data

Even a completely transparent or mechanical selection criteria can lead to an opaque index if the *data* required to determine whether the criteria are met is either not clearly defined. While it is straightforward to obtain data on stock prices and trading data for companies listed on large exchanges, the same is not true with respect to much of the data relied upon in creating indices.

Examples of such a lack of clarity can include vague references to things like “earnings,” without specifying which of the many available measures of earnings. Alternatively, because financial variables change over time, it is often crucial to know the reference date of the data in question. While some indices clearly indicate these reference dates, others do not. Finally, the sources of the data in question may not be obvious. For example, while the CRSP methodology identifies the source of all data used in constructing its Value and Growth Style indices,¹³⁶ others do not.

3. Rule Changes

Another crucial feature of the index methodologies is the ability to *change* the methodology over time. At the limit, if an index’s rules are changing all the time, the index is, for practical purposes, an actively managed portfolio, and the rules themselves are meaningful only in an *ex post* sense. That is, rather than being useful for understanding what the index’s constituents might look like in the future, the methodology would only provide insights into what the constituents look like in the present (or perhaps in the past).

Among the sample of indices that I studied, it is the norm for the methodology documents to empower the entity or group responsible for administering the index (often referred to as the index committee) to change the

133. CONSTRUCTION RULES FOR THE MORNINGSTAR WIDE MOAT FOCUS INDEX, MORNINGSTAR (June 2016) (on file with author).

134. MORNINGSTAR EQUITY RESEARCH METHODOLOGY, MORNINGSTAR 3 (Mar. 2017) (on file with author).

135. See discussion *supra* Section I.A.

136. CRSP U.S. EQUITY INDEXES METHODOLOGY GUIDE, *supra* note 130, at 49-50.

rules from time to time. This power is not just hypothetical. For example, as discussed in Section I.B, these rules change frequently among the two largest families of indices.¹³⁷ Given that these are among the most rigorously documented and professionally managed indices in my sample, there is little reason to believe that other indices change less frequently.

IV. ETFs and Affiliated Indices

Exchange-traded funds (commonly known as ETFs) represent one particular kind of “index investing.”¹³⁸ The overwhelming majority of U.S. ETFs are index-based,¹³⁹ meaning that their primary objective is to track an underlying index.¹⁴⁰ While the general perception is that ETFs are “passive,” we have already seen that the perception of *any* index as passive is flawed. In the ETF context, however, this passivity can become even more tenuous. As I discovered upon reading the fund prospectuses, for a substantial fraction of funds in the U.S. market, the index that the ETF “passively” follows is *itself* created by the fund manager, on an affiliate thereof. If any sort of index investing is delegated management, here, the delegation to the index provider is essentially indistinguishable from delegation to the fund manager. While such funds may be formally tracking the index in question, in practice, it is hard to see the difference between this and a fund that simply makes its own investment decisions directly.

A. About ETFs

Like mutual funds, ETFs are a form of pooled investment vehicle, and are generally registered as investment companies under the Investment Company Act of 1940.¹⁴¹ As such, they are subject to SEC regulation, including disclosure and reporting requirements. There are, however, some differences between ETFs and traditional mutual funds. In a standard open-ended mutual fund, investors buy their shares directly from the fund. When they wish to sell, they sell their shares back to the fund at their net asset value (“NAV”), which is generally calculated at the end of the day.¹⁴² In contrast, ETFs do not sell shares directly to investors. Instead, ETF shares are listed on national stock exchanges, where

137. See discussion *supra* notes 41-45 and accompanying text.

138. For a detailed discussion of ETFs, including their structure and existing regulatory framework, see Henry T. C. Hu & John D. Morley, *A Regulatory Framework for Exchange-Traded Funds*, S. CAL. L. REV. 839 (2018).

139. As I discuss in more detail in Section III.C, out of the 571 funds in my final sample of U.S. ETFs, 18 described themselves as “active” and did not track an index. See *infra* Section III.C.

140. See *Mutual Funds and ETFs: A Guide for Investors*, *supra* note 25, at 19 (“Index-based mutual funds and ETFs seek to track an underlying securities index and achieve returns that closely correspond to the returns of that index with low fees.”).

141. 15 U.S.C. § 80a-1.

142. See *Mutual Funds and ETFs: A Guide for Investors*, *supra* note 25, at 4-5.

Robertson

investors can buy and sell them throughout the day.¹⁴³ Financial intermediaries, known as authorized participants, are the only entities allowed to buy shares directly from the fund or redeem them to the fund, and their trading ensures that the prices remain close to the value of the underlying assets in the fund.¹⁴⁴

B. Why Use an Affiliated Index?

There are several potential reasons why a fund might decide to track an affiliated index. One benign possibility is cost-saving. Perhaps the fund manager can create an index that is just as good, in some meaningful sense, as a well-known “brand name” index. If that is the case, rather than paying a licensing fee to the provider of the brand name index, the fund manager might simply make her own index. These savings can either be passed on to investors, retained by the fund manager, or divided between them. To the extent that any of this is passed on to investors, this explanation suggests that funds that rely on affiliated indices should exhibit lower expense ratios than other comparable funds. This explanation makes the most sense if investors are sophisticated and if they fully understand both the terms of the prospectus and the context of the market.

On the other hand, if investors are unsophisticated, and either do not understand or do not carefully read the prospectus documents, things may not be so benign. For example, suppose that investors have internalized the idea that ETFs are a good investment option because they tend to have lower management fees and fewer agency costs than actively managed funds. Recognizing this, fund managers may create affiliated index-linked ETFs to cater to these investors. While these investors are sensitive to management fees, they do not pay attention to the details of the fund, including the fact that the fund is following an affiliated index. Managers may be able to take advantage of this by increasing their total compensation through other means, perhaps by charging the fund a high licensing fee for the privilege of using the index. In this case, we would expect ETFs tracking affiliated indices to display the same management fees as other ETFs, but to find other ways to pass costs on to investors. These costs would show up in the fund’s expense ratios.

143. *Id.* at 6.

144. *Id.* One distinct feature of ETFs—which differentiates them from both actively managed mutual funds and other index funds is that it is generally quite easy to determine, at any given time, the composition of the fund’s portfolio. While the SEC is currently considering changes to the regulation of ETFs, Exchange-Traded Funds, Securities Act Release No. 33-10515, Investment Company Act Release No. 33140, 83 Fed. Reg. 37,332-411 (proposed June 28, 2018), at the time of this writing, such disclosure is not required of all ETFs under the securities laws. Rather, it is an industry norm, which may be related to the existence of the authorized purchasers mechanism. While the existence of portfolio information undoubtedly increases the transparency associated with ETFs, it does not fully replace the need for an understanding of the underlying index’s construction. While some investors may, with enough sophistication and effort, use this information to reverse-engineer the underlying index’s rules of construction, it is unlikely that the average retail investor will be in a position to do so. Moreover, if the underlying rules are changing over time, even sophisticated investors may find this extraordinarily difficult.

Finally, investors may be totally unsophisticated. For example, as before, suppose investors don't understand much about the market or the products, but they have heard that ETFs are a good investment because they are passive, and therefore desirable. Fund managers may wish to cash in on this popularity, as well as this perception that they represent passive investments. If investors are driven primarily by this misplaced demand for "passive" funds, and not by other features of the fund (including management fees), managers may take advantage of this popularity and charge higher management fees.

While the first explanation is benign, the latter two are more troubling. Both imply that investors are being misled into purchasing investment products that are not what they thought they are getting. The relative plausibility of these three explanations will likely depend on one's view of the sophistication of retail investors. Fortunately, because the three families of explanations have different empirical implications, we can use these implications to construct tests of the underlying theories. This is what I do in the remainder of this Section. In the next Section, I discuss the data that I rely on, and in Section III.D, I perform my empirical analysis. Ultimately, I find evidence most consistent with the second explanation—that managers are taking advantage of the popularity of ETFs and that investors are primarily concerned with management fees.

C. The Sample and Coding Methodology

In order to get a handle on the phenomenon of affiliated index-linked ETFs, I began with all funds in the CRSP mutual fund database, which was obtained through WRDS.¹⁴⁵ I retained all funds flagged as ETFs or ETNs. To ensure that I was capturing funds that focused on equities, I eliminated funds that had less than ninety percent of their portfolios invested in common stock, as well as those that focused on non-U.S. investments.¹⁴⁶ Because of the amount of investment required to hand collect the data, prospectus data was collected only at a single point in time. For consistency, I therefore eliminated all results for which there was no data available as of December 30, 2016. This left me with a total of 603 ETFs.

I then searched the SEC's EDGAR database to obtain prospectus data for each fund on my list. There were seventeen funds for which I was unable to find a match in EDGAR, despite attempting various versions of the fund name. I also

145. I used CRSP rather than Morningstar Direct for this analysis because the CRSP data on fund fees and performance is much easier to work with than the Morningstar Direct data. The main benefit of the Morningstar Direct data is that it contains information on primary benchmark index. Because I hand-collected the index data in this Section, this benefit was not material, making CRSP the preferred data source.

146. Specifically, I eliminated funds with the following Lipper objective types: "CHINA REGION FUNDS," "EMERGING MARKETS FUNDS," "EUROPEAN REGION FUNDS," "INDIA REGION FUNDS," "INTERNATIONAL FUNDS," "INTERNATIONAL REAL ESTATE FUNDS," "INTERNATIONAL SMALL-CAP FUNDS," "JAPANESE FUNDS," "LATIN AMERICAN FUNDS," "PACIFIC EX JAPAN FUNDS," and "PACIFIC REGION FUNDS."

omitted fifteen funds from my final database because they specialized in exclusively non-U.S. investments. After all of this, my final universe of U.S. equity ETFs consisted of 571 funds.

To ensure consistency, I personally hand-collected, read, and coded each prospectus in my sample. I collected information on a variety of topics, including the (1) name of the index that the fund sought to track, (2) the index provider and whether or not the index provider was affiliated with the fund, including the advisor or subadvisor, and (3) whether the fund characterized itself as passive, and if so, how.

Out of the 571 funds in my final sample, 81 were following an index that was created by an affiliate of the fund. Despite this fact, all 81 of these funds described themselves as passive in their prospectuses. In addition to these 81 funds, I recorded 18 funds that explicitly described themselves as “active” or “actively managed” ETFs, which did not track any particular index.

A few examples may help to clarify this phenomenon. Consider, for example, the VanEck Vectors Retail ETF, which, according to its February 1, 2017 prospectus, tracks the MVIS U.S. Listed Retail 25 Index.¹⁴⁷ The prospectus describes the fund as passive, stating that “[t]he Fund, using a ‘passive’ or indexing investment approach, attempts to approximate the investment performance of the Retail Index by investing in a portfolio of securities that generally replicates the [underlying index].”¹⁴⁸ Later in the document, however, in the description of the indices, we are told that “[t]he Retail Index is the exclusive property of MVIS (a wholly owned subsidiary of the Adviser).”¹⁴⁹ Or consider the SPDR SSGA Gender Diversity Index ETF, which, according to its October 31, 2017 prospectus, tracks the SSGA Gender Diversity Index,¹⁵⁰ and is “managed with a passive investment strategy.”¹⁵¹ According to the very same document “[t]he [i]ndex was created and is sponsored by . . . an affiliate of the Fund and of . . . the Fund’s Adviser.”¹⁵²

D. Affiliated Indices and ETF Fees

Having uncovered this puzzling phenomenon, I next explore the reasons behind it. In doing so, I return to the discussion in Section III.B, in which I developed several testable predictions based on three competing explanations. Under the first, most benign, explanation, we would expect to find that expense ratios are lower on average, or at least not higher, among affiliated index-linked

147. VANECK VECTORS RETAIL ETF, PROSPECTUS (Form N-1A) 30 (Feb. 1, 2017).

148. *Id.*

149. *Id.* at 71. The document goes on to say that MVIS “has contracted with Solactive AG to maintain and calculate the Retail Index.” *Id.*

150. SPDR SSGA GENDER DIVERSITY INDEX ETF, PROSPECTUS (Form N-1A) 24 (Oct. 31, 2017).

151. *Id.* at 26.

152. *Id.* at 25.

funds (controlling for other factors) than among the other funds. Under the second, intermediate interpretation, we would expect to find that expense ratios are higher, on average among affiliated index-linked funds, but that management fees are about the same, on average. Finally, under the third, most pessimistic explanation, we would expect to see higher management fees.

I begin with a univariate analysis, which includes a series of controls for fund style and year. These analyses are conceptually similar to estimating the difference in means between funds that use affiliated indices and those that do not. To do so, I estimate a series of OLS regressions of the form:

$$y_{it} = \alpha + \beta_1 \times \text{Affiliate}_i + \Psi_{it} + \varepsilon_{it}$$

where y_{it} is one of either expense ratio, management fee, or turnover ratio of fund i at time t , Affiliate_i is an indicator variable equal to 1 if fund i tracks an affiliated index, and Ψ_{it} is a vector of controls. For robustness, I run the analysis in a variety of possible ways. I use annual data on expense ratio, management fee and turnover ratio for years 2015 through 2017.¹⁵³ The results are presented in Table 7. Column (1) contains the results using style x year fixed effects, which is the most robust specification, as the control allows the relationship between style and the outcome variable to vary by year.¹⁵⁴ Column (2) contains the results using style fixed effects and year fixed separately, and Column (3) contains the results using only style fixed effects. In all specifications, standard errors are clustered by fund, and standard errors are in parentheses.

The first thing to notice is that the results in all three panels are very stable, both in terms of magnitude and statistical significance, across specifications. This suggests that the results are not being driven by the specific pattern of controls that I am using. The results in Panel A indicate that, on average, expense ratios are higher among affiliated index-linked funds. At the same time, the results in Panels B and C indicate that, on average, the management fees and turnover ratios are indistinguishable between the two groups.

153. I limit my window to the period from 2015 through 2017 because my affiliated index data is from the second half of 2017, using funds that existed at the end of 2016. Because the data must be hand-collected, collecting the data for multiple years was infeasible.

154. For the purposes of the analysis in this Section, I rely on the style classification of each *fund* in the CRSP database, and not on the style classifications of *indices* from Part I. Specifically, style is defined by the CRSP objective code of the ETF. This ensures that my results are based on standard style classification.

Table 7: Univariate Relationship between Affiliated Index and Fund Characteristics

	(1)	(2)	(3)
<i>Panel A – Dependent Variable: Expense Ratio</i>			
Affiliated	0.0668** (3.15)	0.0666** (3.19)	0.0660** (3.17)
Style Fixed Effects	NO	YES	YES
Year Fixed Effects	NO	YES	NO
Style x Year Fixed Effects	YES	NO	NO
Standard Errors	Cluster by Fund	Cluster by Fund	Cluster by Fund
N	1481	1481	1481
<i>Panel B – Dependent Variable: Management Fee</i>			
Affiliated	-1.06 (-0.33)	-1.17 (-0.37)	-1.21 (-0.38)
Style Fixed Effects	NO	YES	YES
Year Fixed Effects	NO	YES	NO
Style x Year Fixed Effects	YES	NO	NO
Standard Errors	Cluster by Fund	Cluster by Fund	Cluster by Fund
N	1481	1481	1481
<i>Panel C – Dependent Variable: Turnover Ratio</i>			
Affiliated	-4.95 (-0.88)	-4.91 (-0.90)	-4.83 (-0.88)
Style Fixed Effects	NO	YES	YES
Year Fixed Effects	NO	YES	NO
Style x Year Fixed Effects	YES	NO	NO
Standard Errors	Cluster by Fund	Cluster by Fund	Cluster by Fund
N	1476	1476	1476

t statistics in parentheses. * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

This table presents the results of regressions of three different dependent variables: fund expense ratio (Panel A), fund management fee (Panel B) and fund turnover ratio (Panel C), on a dummy equal to one if the index being tracked by the ETF is an affiliated index, and zero otherwise. All dependent variables are multiplied by 100 (i.e., measured in percentage points) for ease of interpretation. All regressions contain controls for fund style, fund style and year, or style x year, as indicated. Standard errors are clustered by fund.

The first result, that expense ratios are *higher*, is inconsistent with the first explanation, and the fact that management fees are *not* higher, is in tension with the third explanation. At the same time, the fact that the management fees are the same, statistically speaking, while the expense ratios are higher, is consistent with the second explanation. This explanation is bolstered by the fact that the turnover ratio is also statistically indistinguishable between the two groups. The

reason for this is simple: in addition to management fees, trading costs add to the expenses associated with running a fund. The more a fund trades (i.e., the higher its turnover ratio), the more trading costs it incurs. The fact that turnover is not statistically higher at affiliated index-linked funds suggests that this is not what is going on.

We can test this more directly by adding turnover ratio as a control in the original regression. Moreover, because management fees—at least to the extent that they are actually paid—are *also* included in the expense ratio, I also include that as a control variable. The results are presented in Table 8.¹⁵⁵

Table 8 confirms that both management fee and turnover ratio are positively associated with expense ratio. However, controlling for these factors, affiliated index-linked ETFs still have higher expense ratios. Specifically, Columns (1) and (2) show that, controlling for turnover ratio and management fees, respectively, affiliated index-linked ETFs have higher expense ratios than other ETFs. In Column (3), I control for both turnover ratio and management fees at the same time and find that affiliated index-linked ETFs still have higher expense ratios. Importantly, the coefficient on *Affiliated* hardly changes as we move from Column (1) to Column (3), despite the fact that the variables that are added are themselves statistically significant. These results show that even controlling for these two other factors, affiliated index-linked funds still have higher expense ratios. In fact, the coefficients on the *Affiliated* dummy in Columns (1) through (3) are actually larger, both in terms of magnitude and statistical significance, than the ones in Panel A of Table 7.¹⁵⁶ Next, because of the possibility that expense ratio and management fees might be *differentially* related to expense ratios for funds that use affiliated indices relative to those that don't, in Column (4) I also include interaction terms of the form *Turnover Ratio x Affiliated* and *Management Fee x Affiliated*. As the results in Column (4) make clear, while these interaction terms are not statistically distinguishable, their inclusion substantially increases the point estimate of the coefficient on *Affiliated*.

Management fees and turnover are not the only features of a fund that may be associated with expense ratios. Recognizing this, I introduce two additional controls in Column (5). The first is a control for the fund's age, measured as the natural logarithm of the number of years since the fund was first offered, which

155. In untabulated results, I run versions of the regressions presented in Table 8 using *Management Fee* as the dependent variable rather than *Expense Ratio*. In all specifications, the point estimate of the coefficient on *Affiliated* is negative, although it is generally statistically indistinguishable from zero. While not dispositive, these results also fail to provide evidence in favor of the third explanation.

156. In untabulated results, I also vary the fixed effects. Specifically, as in Table 7, I use style fixed effects and style and year fixed effects. Because the effect of the coefficients of interest hardly changes, I omit these results for the sake of parsimony.

Robertson

has been shown to be associated with expense ratios.¹⁵⁷ The second is a control for the size of the fund, which has also been shown to be associated with expense ratios.¹⁵⁸

Table 8: Relationship between Affiliated Index and Expense Ratio

	(1)	(2)	(3)	(4)	(5)
<i>Dependent Variable: Expense Ratio</i>					
Affiliated	0.0726*** (3.72)	0.0705*** (3.90)	0.0750*** (4.38)	0.132** (2.72)	0.129** (2.87)
Turnover Ratio	0.00121*** (3.74)		0.00102*** (3.66)	0.00105*** (3.46)	0.000791*** (3.59)
Management Fee		0.00348** (3.10)	0.00311** (3.04)	0.00326** (2.75)	0.00419*** (4.85)
Turnover Ratio x Affiliated				-0.000536 (-1.12)	-0.000442 (-1.07)
Management Fee x Affiliated				-0.00118 (-0.77)	-0.00193 (-1.48)
ln(Age)					0.0294** (3.04)
ln(Size)					-0.0334*** (-7.08)
Style x Year FE	YES	YES	YES	YES	YES
Standard Errors	Cluster by Fund	Cluster by Fund	Cluster by Fund	Cluster by Fund	Cluster by Fund
N	1476	1481	1476	1476	1449
R-squared	0.371	0.428	0.521	0.526	0.658
Adjusted R-squared	0.333	0.393	0.492	0.496	0.636

t statistics in parentheses. * p<0.05, ** p<0.01, *** p<0.001

This table presents the results of regressing fund expense ratio on a dummy equal to one if the index being tracked by the ETF is an affiliated index, and zero otherwise. Columns (1) and (2) contain controls for the fund's turnover ratio and management fee, respectively, and column (3) contains controls for both simultaneously. Column (4) adds interaction terms of the form *Turnover Ratio x Affiliated* and *Management Fee x Affiliated*. Column (5) adds a control for fund age, as measured by the natural logarithm of the number of years since the fund was first offered, as well as a control for fund size, as measured by the natural logarithm of the total AUM of the fund. Expense ratio, management fee, and turnover ratio are multiplied by 100 (i.e., measured in percentage points) for ease of interpretation. All regressions contain controls for fund style x year fixed effects. Standard errors are clustered by fund

157. See generally Stephen P. Ferris & Don M. Chance, *The Effect of 12b-1 Plans on Mutual Fund Expense Ratios: A Note*, 42 J. FIN. 1077 (1987); D. K. Malhorta & Robert W. McLeod, *An Empirical Analysis of Mutual Fund Expenses*, 20 J. FIN. RES. 175 (1997).

158. See generally Ferris & Chance, *supra* note 157; Malhorta & McLeod, *supra* note 157.

While the coefficient on *Affiliated* falls slightly in column (5) relative to Column (4), it remains positive and statistically significant at the 1% level.¹⁵⁹ This indicates that the association between the use of affiliated indices is not subsumed by the inclusion of these additional controls. These results represent additional support in favor of the second explanation—that investors are attracted to ETFs and are sensitive to management fees, but that they do not necessarily notice the other costs that are associated with affiliated index-linked ETFs. That being said, it is important to note that there is no causal identification in this empirical design—the results simply indicate an association, not a causal link. As such, more work is needed to more completely understand the relationship between expenses—and ultimate performance—and the use of affiliated indices.

V. Implications

Having established these empirical results, I now tie these results back to the discussion in Part I. I do so in three parts. First, I argue that the SEC’s current disclosure rules relating to indices are flawed. Both in the context of benchmarking and index investing, the SEC’s current rules result in disclosures that provide the wrong information to investors. Building on this argument, I then address these two uses—index investing and benchmarking—separately. In the context of index investing, I provide a mixture of conceptual implications and concrete policy proposals aimed at better aligning the current regulatory regime with market realities. I then turn to the use of indices for benchmarking.

A. *The SEC is Requiring Disclosure of the Wrong Information*

Put in the simplest possible terms, the central finding in the empirical portions of this Article is that we should be much more thoughtful about the use of indices. This is true both in the context of their use as benchmarks and in the context of index investing. For example, the degree of heterogeneity across indices, documented in Part II, makes it clear that indices are far from interchangeable. This is true even across indices that, based on their descriptions, are intended to capture the same or similar things. As we saw in some detail, two indices that purport to capture the same factor (such as, for example, “growth”) may do so in very different ways, and two large-cap indices may in fact contain firms of different sizes.¹⁶⁰ As a consequence, in order to understand what the index is actually doing, one must, at a minimum, carefully examine the methodology underlying the index. Moreover, to the extent that the methodology

159. For further robustness, I also estimate a version of the model in Column (5) that omits the interaction terms. The coefficient on *Affiliated* remains positive and statistically significant at the 1% level, although the magnitude of the point estimate falls to substantially.

160. See discussion *supra* Section II.C.3.

Robertson

is vague or opaque,¹⁶¹ even a careful examination may not be sufficient to fully understand how the index operates.

Consider now the use of indices as benchmarks. The rationale for requiring mutual funds to present their performance relative to a benchmark is to help investors better evaluate the performance of the fund in question.¹⁶² What this means in practice, however, is that investors are presented with little more than the name of the benchmark index (or indices), and the performance of the fund relative to that index (or indices). It is easy to see why such a comparison is of, at best, limited value: it follows from simple logic that any comparison between two objects—for example, A and B—is as much about B as it is about A. More concretely, if the investor does not understand the operation of B (in this case, the benchmark), any comparison that she makes between A (in this case, the mutual fund in question) and B (the benchmark) will be problematic.

Because of this, given the heterogeneity across indices that purport to capture the same or similar things, relying solely on the name of an index—without having done extensive research into its construction—is at best meaningless (since such an investor cannot reasonably be expected to understand how the benchmark operates). At worst, to the extent that some investors’ perceptions of how the index is constructed differ from its true construction, such a comparison could result in confusion. Perversely, rather than helping investors make more informed decisions, requiring such comparisons actually has potential to be misleading.¹⁶³

Rather, for a benchmark index to be useful to investors (and potential investors), the investors need to be able to tell what that benchmark index is

161. See discussion *supra* Section II.D.

162. See discussion *supra* Section I.A.1.

163. I note that under current rules, funds are permitted to compare themselves to multiple benchmarks. For the purposes of the analysis in Part II, I relied upon the primary prospectus benchmark, as reported by Morningstar Direct. It is, of course, possible that some, and even many of the funds in my sample reported their performance relative to other indices beyond the one captured in this data. This fact may complicate the evaluation of the usefulness of these benchmarks, but it does not materially alter these conclusions. To the extent that investors are presented with multiple benchmarks, this may place *additional* strains on their cognitive capacity, as they must now investigate the construction and attributes of multiple indices rather than just one. One might counter that investors could choose to rely solely on one of the indices presented, selecting for example the most well-known index in the group, or one that they were already familiar with. While this might, in certain circumstances, mitigate the problem, it does not eliminate it, as the fact remains that the title alone is insufficient for making meaningful comparisons. Moreover, given the advances in behavioral finance demonstrating the extent to which phenomena such as anchoring and priming can affect individual decisionmaking, the possibility remains that investors may be particularly affected by the primary benchmark, even if they are presented with alternative benchmarks. For a discussion of anchoring, see Nicholas Barberis & Richard Thaler, *A Survey of Behavioral Finance*, in *HANDBOOK OF THE ECONOMICS OF FINANCE* 1053, 1066 (2003) (describing anchoring as a phenomenon where individuals often start with some initial value and then adjust away from that “anchor” and nothing that this adjustment is often insufficient, leading to a final belief that it skewed towards the initial anchor). For a discussion of priming, see Paul Dolan, Antony Elliott, Robert Metcalfe & Ivo Vlaev, *Influencing Financial Behavior: From Changing Minds to Changing Contexts*, 13 *J. BEHAV. FIN.* 126, 131-32 (2013) (describing priming as the phenomenon where individuals’ subsequent behavior can be influenced by exposure to subtle stimuli, including visual stimuli).

actually *doing*. To the extent that the SEC is committed to maintaining its position that index comparisons are superior to comparisons to competitors (or peer funds),¹⁶⁴ relying on the index name alone is insufficient. At a minimum, for such disclosures to be of any use to investors at all, they must include a description of how the benchmark index is constructed that is sufficiently detailed and sufficiently clear as to allow investors to make reasonably informed comparisons. Given the cognitive constraints that many retail investors face, it is not clear how plausible it is that one could craft such a description. I return to this issue in Part IV.C.

The construction and management of the underlying index is even more important in the context of index investing, since the index is effectively making portfolio allocation decisions on behalf of the mutual fund or funds that track it. Here again, to the extent that investors are receiving information about the indices in question, they are receiving it about the wrong things.

Yet again, for all the reasons discussed in the last few paragraphs, telling investors the name of the index that an index fund is tracking does not give investors enough information to meaningfully understand how the fund will operate.¹⁶⁵ And while most mutual fund offering documents provide some additional information about the underlying index—which is certainly better than what investors receive in the benchmark context—that information remains insufficient. Once we recognize that index investing is simply a form of delegated management, it becomes clear that the disclosure regarding these indices should reflect this underlying reality. I discuss this further in Part IV.B.

B. Recognize that Index Investing is Delegated Management

One clear implication of the analysis in Parts II and III has to do with “index” investing. Every one of the over 600 indices in my comprehensive sample—and the over 550 in my index fund subsample—gave the index provider at least *some* amount of discretion. Even the most mechanical indices—those that follow strict quantitative rules—allow for some discretion on the part of the index committee. In the context of a fund that tracks the index, this discretion implies that the index provider’s decisions will have a flow-through effect on the investor’s portfolio. This in turn implies that, far from being passive, index investing is properly understood as a form of delegated management.

To be sure, the amount this delegation varies significantly across indices. While some relied largely on quantitative rules, others gave substantial amounts of discretion to certain individuals, which is hard for a third party to anticipate, particularly when the identities of the individuals in question are not clearly

164. See *supra* text accompanying note 24.

165. See *supra* notes 160-164 and accompanying text.

disclosed.¹⁶⁶ Moreover, many indices rely on information that third parties, such as investor and prospective investors, cannot readily obtain,¹⁶⁷ making it difficult to argue that the investor knows precisely what the index will do in the future. Others still have features that are deliberately opaque, and which make it impossible for a third party—including an investor or potential investor—to determine how exactly it is constructed. For example, billions of dollars are indexed to indices that are explicitly relying on proprietary features,¹⁶⁸ something that can only be referred to as delegated management. Hundreds of billions more are indexed to indices that are, for practical purposes, executing strategies similar to what one would expect to find in an “actively” managed fund.¹⁶⁹

Even if the rules are fairly precise and allow for relatively little discretion, indices need to allow room for the rules to change, or to resolve circumstances as they arise. In theory, this need not imply delegated management. For example, the way the index is going to deal with these could be announced well in advance and communicated to all investors who own shares in such funds, giving the investor the opportunity to remove her funds if she is unhappy with the decision. In practice, however, this is highly implausible. For this to work, the investor would have to keep a close watch on her portfolio, and, more importantly, on what the index manager is doing. Because these changes happen rather frequently,¹⁷⁰ this would imply that the investor is spending substantial amounts of time investigating the implications of these changes on a regular basis. While this might be possible in theory, doing so runs counter to the very concept of “passive” investing. The whole point of “passive” investing is that the investor doesn’t have to pay attention to her portfolio. If an investor is constantly monitoring the underlying index, she may not necessarily be delegating the management of her portfolio, but she is also not meaningfully engaged in what would conventionally be called passive investing.

Of course, there is nothing inherently wrong with delegated management. While scholars have expressed concerns about the corporate governance implications of institutional investors,¹⁷¹ for many investors, being able to delegate management of their portfolio to a third party is a boon. A well-diversified portfolio—something that many portfolio managers offer—generally has far less risk than the type of concentrated portfolio that many individual

166. Some examples of the former include the CRSP family of indices, see *supra* note 130 and accompanying text, and the Russell indices, see *supra* note 135 and accompanying text. Some examples of the latter include the Dow Jones Industrial Average, see *supra* notes 40-41 and accompanying text; *supra* note 131 and accompanying text, and the Morningstar Wide Moat index, see *supra* notes 134-135 and accompanying text.

167. See, e.g., *supra* Section II.D.2.

168. See *supra* Section II.C.4.

169. See *supra* Section II.C.4.

170. See *supra* Section II.D.3.

171. See Bebchuk et al., *supra* note 29.

investors, if left to their own devices, tend to hold.¹⁷² Moreover, individual investors tend to exhibit trading patterns and other behaviors that systematically reduce the returns on their investments,¹⁷³ something that they may be able to avoid by engaging in delegated management.

Moreover, the form of delegated management implied by investing in an “index fund” may also be better—from the perspective of the investor—than other forms of delegated management, such as that of an actively managed mutual fund. Index funds tend to have far lower management fees,¹⁷⁴ and thus tend to offer superior returns to investors. My point is not that there is anything wrong with the delegated management implied by an index fund, only that it is still delegated management and should be recognized as such.

1. Proposal: Recognize that the Underlying Index Represents a Fundamental Attribute of an Index Fund

Nevertheless, this delegation may have other consequences, particularly as it relates to investor protection.¹⁷⁵ While a mutual fund cannot deviate from its fundamental policies, as stated in its registration statement, without a shareholder vote,¹⁷⁶ there is no restriction on an index’s ability to change its methodology. This asymmetry leaves investors in “index” funds with fewer protections, and potentially facing higher risks, than investors in actively managed mutual funds.

This risk is particular acute in the context of index funds that track a specialized index, which is not being used by any other entities. Whereas an index that is being used by many market participants may have an incentive to maintain the integrity of the index, this incentive is dulled when the index has only one user. This may be even more extreme in the case of ETFs that follow affiliated indices, where the *same* entity (or an affiliate thereof) is managing both the index and the fund. As a result, the protections afforded to investors by the Investment Company Act of 1940 in the context of delegation to *managers* do not exist in the context of delegation to an *index provider*.

172. Brad M. Barber & Terrance Odean, *The Behavior of Individual Investors*, in THE HANDBOOK OF THE ECONOMICS OF FINANCE 1533, 1560-1563 (2013) (surveying evidence that individuals fail to optimally diversify their portfolios).

173. *See generally id.*

174. *See Trends in the Expenses and Fees of Funds, 2017*, INV. COMPANY INST. RES. PERSP. 1 (Apr. 2018), <https://www.ici.org/pdf/per24-03.pdf> [<https://perma.cc/UYD2-RLJU>] (noting that in 2017, the average expense ratio was 0.78% for actively managed equity mutual funds, compared to 0.09% index equity mutual funds).

175. This delegated management may also have corporate governance implications. This is likely to be most relevant in the context of delegation to very large indices like the S&P 500. I discuss this implication in a related paper. *See generally* Robertson, *supra* note 7.

176. 15 U.S.C. § 80a-13(a)(3) (2018) (prohibiting investment companies from deviating from certain investment policies, as well as “any policy recited in its registration statement pursuant to section 80a-8(b)(3) of this title,” unless authorized to do so by the vote of a majority of its outstanding voting securities); *see also* 15 U.S.C. § 80a-8(b)(3) (2018) (consisting of “all policies of the registrant, not enumerated in paragraphs (1) and (2), in respect of matters which the registrant deems matters of fundamental policy”).

Fortunately, there is a simple solution to this problem. Once we recognize that delegating to an index is no different than delegating to a fund manager, we can craft a solution based on the existing rules. Any time the underlying index makes a change that, if made by the fund manager in a comparable actively managed fund, would trigger a vote, the fund manager is required to hold a vote on retaining the index. This simple change would harmonize the protections offered to investors in the two types of funds.

An additional benefit of this proposal is that it does not rely on the creation of an entirely new regulatory apparatus for indices. Instead, it simply relies on the existing regulatory regime for mutual funds, making it simple to implement. Specifically, the proposal would not place any direct obligations on the underlying indices. Instead, the obligation would be on any fund that chose to track an index. This obligation would then flow through to the index provider through market forces: index providers generate revenue by licensing the use of their indices to market participants, including index funds. Because any index that refused to cooperate with fund managers would be opening the fund up to potential liability, fund managers would simply require that the index provider provide the necessary information. This would include information sufficient to determine whether or not a shareholder vote is required, and if it is, sufficient disclosure for the vote to proceed. While indices would be free to decline to provide this information, doing so would almost certainly imply a loss of licensing fees, since fund managers are unlikely to stick with an index that refuses to allow them to meet their obligations.

Structuring the obligation in this way would have three major benefits. First, by implicating only those indices that are tracked by index funds, the rule avoids the risk of being over inclusive. As discussed above, there are tens of thousands of different financial market indices.¹⁷⁷ A rule that applied to all indices would be like using a sledgehammer to crack a walnut. In contrast, this approach is narrowly tailored to fill a specific regulatory gap and solve the problem at hand. Second, such a rule would implicitly shift the obligation to monitor the underlying indices from individual fund investors to the fund's managers. Because these individuals are vastly better suited for this role, the shift is likely to be efficiency enhancing, and therefore increase total wellbeing. Finally, by virtue of this shift in monitoring obligations, fund managers are likely to demand more and better disclosures from index providers. Even if these disclosures never become available to the broader market, the existence of the scrutiny alone is likely to have a disciplining function on index providers.

Of course, the shareholder voting mechanism required by the Investment Company Act is not without its critics. For example, John Morley and Quinn Curtis have argued persuasively that shareholder voting is fraught with problems in the mutual fund context, and that a far better approach to mutual fund

177. See *supra* note 59 and accompanying text.

governance is to take exit rights seriously.¹⁷⁸ This proposal is not intended to take issue with their argument. Rather, it should be interpreted as a call to recognize the importance of the underlying index to an index fund, and to harmonize the regulatory treatment of index funds with those of actively managed funds. To the extent that the SEC wants to preserve the shareholder voting mechanism for fundamental policies, it should recognize that, in the context of index funds, what it should look to is the underlying index. If instead the SEC wishes to move away from this and towards another mechanism—such as, for example, a meaningful disclosure mechanism—this proposal should not be viewed as an argument against such a change. Rather, the point is that any such regulatory change should recognize the unique importance of the underlying index to an index fund and should proceed accordingly.

2. Proposal: Increase Index Fund Disclosures Around the Underlying Index

The results in Part III raise additional consumer protection concerns. Specifically, the results support the idea that funds may be taking advantage of the popularity of ETFs—and the idea that they have low management fees—while passing costs along to investors in other ways. One potential avenue for this is licensing fees. For example, if, rather than paying licensing fees to a third party, a fund that tracks an affiliated index is essentially paying a licensing fee to itself. In both cases, this licensing fee would count as an expense of the fund and would show up in the fund's expense ratio. However, while in the former case the fee represents an arm's length transaction, the latter is, at best, a transfer among affiliates, raising the possibility that the prices may be set strategically. To the extent that investors are more sensitive to a fund's management fees than they are to its expense ratio, it might not be surprising for funds to take advantage of this by charging themselves higher licensing fees than they would be prepared to pay to a third-party index provider.

I emphasize that while this story about licensing fees is consistent with the results in Part III, I have no specific evidence of such behavior. All the same, the potential for such behavior is problematic. One possible solution to this problem is to simply ban the use of affiliated indices by index funds, forcing them to instead use third party indices. While this might take care of the problem, prohibition is a blunt instrument, and it is not an ideal solution. As with anything else in financial markets, doing so runs the risk of both stifling innovation and generating unintended consequences.

178. See generally John D. Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L.J. 84 (2010). While many of Morley and Curtis's policy proposals involve directly regulating features that are viewed as problematic, central to their argument is the fact that exit plays a uniquely important role in the mutual fund context. This discussion picks up on this latter aspect of their analysis.

Instead, the consumer protection concerns can be addressed through more and better disclosure. At present, such disclosures are not specifically required. As I found upon reading the prospectus documents, these disclosures, if they exist at all, are often incomplete, hard to locate, and difficult to interpret. And yet the information about the underlying index is of crucial importance to investors in index funds in a way that it is not for investors in active funds. The required disclosures should reflect this.

Specifically, any fund that has, as its objective, to track a particular underlying index should be required to provide clear, consistent, and prominent disclosures about that index. These disclosures should include (1) the identity of the index provider and (2) whether any person or entity affiliated with the fund in any way (i) is affiliated with the index provider, (ii) was involved in designing the index, (iii) has any ongoing ability to influence the index, or (iv) has been involved in any changes to the index, and if so, what those changes were. The disclosures should then go on to include the compensation of the individuals involved in the creation and management of the index, as well as any conflicts of interest they may face.¹⁷⁹

In addition, the section should also include a simple disclosure of the licensing fees paid by the fund to the index provider. The reason for this is simple: just as actively managed mutual funds must disclose their management fees, index funds should disclose the fee that they are paying to the entity that is responsible for selecting investments—the index provider. This amount should be expressed both in terms of the contribution of these fees to the fund’s expense ratio and as a percentage of the fund’s assets under management. These index disclosures should be placed in their own section immediately following the “Principal Investment Strategy” section.

These disclosures would help to clarify the relationships between indices and funds and would be particularly useful in contexts where the fund has a close relationship with the underlying index. Of course, an understanding of how the index operates is important even in the context of indices that are truly at arm’s length from the fund. For example, at present, mutual fund investors are entitled to detailed disclosures about the identity and compensation of fund managers.¹⁸⁰ In contrast, investors are generally provided with virtually no information about the identity of compensation structure of the individuals responsible for managing the index that the fund tracks. If we recognize that in the context of index investing, the ultimate delegatee is the index creator, it is hard to find a justification for this differential treatment.

179. Given the complexities of this market, the precise details of what these disclosures should look like requires further empirical and theoretical study.

180. See, e.g., SEC Form N-1A, *supra* note 20, Item 5(b) (requiring disclosure of the names and other information associated with the fund’s portfolio managers—i.e., the individuals primarily responsible for the day-to-day management of the fund’s portfolio); Item 20(b) (requiring disclosure of the structure of each portfolio manager’s compensation, as well as the method used to determine such compensation).

Fortunately, here again there is a simple solution. In addition to the above discussed disclosures about the index, index funds should also be required to provide disclosures about the individuals responsible for the management of the *index* that are analogous to the disclosures that are currently required about the individuals responsible for managing the *fund*.

This solution would help to limit the risk to investors without stifling financial market innovation. Funds would be free to create their own indices and to charge whatever licensing fees they wished. Moreover, indices would be free to operate in any way that they wished. An index that, for whatever reason, did not want to allow public disclosures related to its managers would be free to decline to do so. Of course, the cost of doing so would be that mutual funds would no longer be able to track these indices, thereby depriving the index creator of potentially lucrative licensing fees. Index creators would be free make their own business decisions about which of these options to choose. Similarly, this solution would place no restrictions on investor choice as it relates to index funds. Instead, it would simply ensure that they are fully informed about one of the most important features of such funds.

C. Rethink the Use of Indices as Benchmarks

A second set of implications of the analysis in Part II has to do with the use of indices as performance benchmarks. As discussed in Section I.C, any comparison of a portfolio against a benchmark is as much about the benchmark itself as it is about the portfolio. Of course, there is nothing inherently wrong with this—it is just a fundamental feature of the way comparisons work, and is true for any benchmark, not just in financial markets.¹⁸¹ As long as one has a clear understanding of the material features of the benchmark index, such comparisons can be quite useful.

Problems arise, however, when one does not have a clear understanding of the underlying benchmark. At best, such a comparison would be useless, in that they would provide no useful insights into how to interpret the performance of the portfolio of interest. This could be the case if the investor was aware of the fact that she does not understand the benchmark. In that case, a rational investor would realize that the index provides her with no useful information. Because she is always free to disregard information that she does not believe is useful, the investor could simply ignore the benchmark. As a result, while reporting the returns on the benchmark does not help the investor, at least she is not harmed by it.

Of course, this assumed that the investor was fully rational and knew that she did not understand the benchmark well enough for it to be useful. If this is

181. For example, consider a literal benchmark: a marking on a tool bench. Such a marking can be useful in measuring the length of another other object—for example, a piece of wood—only to the extent that one has a clear idea of the length of the benchmark itself.

not the case, providing the benchmark could actually be misleading, leading an investor (or potential investor) to an erroneous conclusion. Unfortunately, the more the investor (or potential investor) *believes* the benchmark to be relevant, the more likely she is to find herself in the latter case.

The analysis in Part II suggests that, simply by the sheer number of different indices being used as benchmarks and the sheer amount of diversity across these indices, at least some investors are likely to find themselves in the latter position. While it may be plausible for an investor to have a reasonable understanding of the working of a small number of indices,¹⁸² the idea that she would have a solid understanding of a large number of them is implausible. Even assuming that she could access the required information, since the vast majority—nearly eighty percent—of indices in my full sample are being used by only a *single* fund, it is unlikely that she would find it worthwhile to invest the time required to understand it. Even among the non-index fund subsample—the mutual funds that are *not* index funds—the median index is being used by only two funds, demonstrating that this is not a concern that is unique to index funds. Moreover, because of the diversity across indices, she cannot simply transfer her knowledge about one index to another, as doing so is as likely to result in error as it is to be helpful. Finally, for the same reasons that index investing should be understood as delegated management, the assumption that the investor would be able to access the required information is unlikely to hold.

1. Proposal: Reconsider the Benchmarking Requirement

One potential solution to this problem is to reconsider the benchmarking requirement. It is quite possible that the requirement made good sense in 1993 when it was first adopted: my analysis is based on data from 2017 and later, and it is entirely possible that the landscape of securities indices has changed dramatically in the intervening decades. However, given the features of the market today, it may be time for the SEC to reconsider its conclusion that benchmarks provide a better comparator than other investment opportunities, such as competitor funds.¹⁸³

Naturally, the use of competitors is not a silver bullet, and this should not be taken as a full-throated argument for the wholesale rejection of benchmarking. Rather, my argument is more modest: in light of this evidence about the current landscape of securities indices, the SEC should, at the very least, reconsider its benchmarking requirement.

182. I use the term “may” with caution. In fact, even the S&P 500, arguably the most prominent index of the U.S. stock market, and the most popular index in my sample by a significant margin, is poorly understood. See Robertson, *supra* note 7.

183. See *supra* text accompanying note 24.

2. Proposal: If the Benchmark Requirement is Retained, Require Sufficient Disclosure to Allow for Meaningful Comparisons

Notwithstanding the foregoing discussion, a colorable case can be made that, in the absence of a clearly implementable and demonstrably superior alternative, mutual funds should continue to provide performance information relative to a benchmark. While one could reasonably believe that benchmarks are, at present, the most practicable option, it does not follow that the status quo should be maintained. Rather, to the extent that the SEC chooses to retain its benchmarking requirements, these requirements should be modified so as to provide enough information for investors to meaningfully use them.

This may be more easily said than done. As discussed previously, for a benchmark to provide any useful information to an investor, that investor must be able to determine how the benchmark index is constructed.¹⁸⁴ Moreover, it must do so in a way that it both short enough that investors will actually read it, and simple enough for the average retail investor to understand it. These requirements are not at all trivial and determining the best way of achieving this would require further study.

VI. Conclusion

In this Article, I provide new insights on the landscape of U.S. stock market indices. I document substantial heterogeneity across the universe of indices used as benchmarks for U.S. mutual funds and as the index underlying index funds. I then show that a substantial proportion of ETFs track indices of their—or their affiliates'—own making. My findings shed light on a previously understudied corner of the financial markets and have substantial implications for investor protection.

184. See discussion *supra* Section IV.A.