External Advisory Committee Discussions

March 2020
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Introduction

FTSE Russell index standards are underpinned by strong governance and an emphasis on transparency. To ensure that our indexes continue to meet investors’ requirements, independent committees advise on their design to make sure that they each evolve to continue to meet the highest standards in the industry.

To promote transparency, this note provides a summary of the topics presented to the advisory committees in Q1 2020.

1. Equity

March 2020 Index Rebalance

As well as the normal agenda items, the Americas & EMEA regional equity advisory committees and the Policy Advisory Board reflected on the considerations around the potential suspension of the March index review because of the volatile market activity resulting from the Coronavirus COVID-19 pandemic which seemed to be exacerbated in some cases by Government directives for people to work from home.

Deliberation took place on whether systems’ technology would allow FTSE Russell to halt a review rebalance once the changes have been announced to the market and the daily review file updates delivery process had commenced was possible. Simultaneously index clients were canvassed on their own preference. Discussions were also held with the UK Financial Conduct Authority and the US Securities and Exchange Commission.

The outcome of FTSE Russell’s deliberations was communicated to the market on 13 March (see: link); at the March meetings post-mortem, some committee members voiced their continuing preference for the suspension of the index review whilst others commented that it might have been an even more complex situation if FTSE Russell had not gone ahead.

To assist clients and to reduce index turnover, the announcement included FTSE Russell’s announcement to split out the final tranche of the implementation of the China A Shares and Saudi Arabia inclusion in the
FTSE Global Equity Index Series (GEIS) and extend it into the June review (see: link); positive feedback was received from the market on this decision.

The regional advisory committees also discussed the following items:

**Minimum Voting Rights**

The advisory committees were invited to consider whether the definition of voting rights in the FTSE Russell index methodology needs to be clarified. The regional advisory committees were consulted in advance of the meeting to gauge their appetite for potential enhancements to the current 5% minimum voting rights hurdle and to aid discussion at the meeting. Most respondents to this initial consultation supported the view that shares described in the ground rules as providing only legal minimum voting rights or being disclosed as ‘non-voting’ should be viewed as having zero voting rights. At the meetings, certain committee members voiced support for inclusion of the entitlement to vote on the election of a board of directors, mergers or dissolution in the rules as a test of voting rights. Under the current rule, companies providing legal minimum rights or disclosing shares as non-voting will be viewed as having zero voting power for the purposes of the voting rights rule. FTSE Russell will consider possible enhancement to the rule in the future.

**Non-Eligible China A Shares in Stock Connect**

In December, the results of the Shanghai and Shenzhen index rebalances were announced after the quarterly GEIS review announcement. In order to minimise turnover, FTSE Russell aligned the removal of those China A Shares which had become de facto ineligible for inclusion in the FTSE Stock Connect index (the underlying universe for China A Share inclusion in GEIS) with the implementation of the December review. The regional committees expressed a preference for the non-eligible stocks to be removed from FTSE Russell indexes as soon as possible with T+2 notice at future review rebalances. FTSE Russell will make a determination based on this feedback and announce any changes to the wider market.

**Inclusion of Local P Chip Line in FTSE Russell Indexes**

At the December 2019 meeting, the regional committees supported the screening of the Hong Kong line (P Chip) of a Chinese company for index inclusion in the FTSE China 50 Index and the FTSE MPF Index Series at the June 2020 quarterly review. At the March 2020 meeting, the Asia Pacific committee supported a staggered implementation over three tranches to reduce market impact and turnover. Following approval by the FTSE Russell Product Governance Board, the planned index treatment was announced; see hyperlink: Alibaba Group Holding (P Chip) – Treatment in FTSE Indexes - Published 7 April 2020
Application of Environmental, Social & Governance (ESG) Exclusions

In response to a client request, the Americas & EMEA regional advisory committees and the Policy Advisory Board were invited to comment on whether certain exclusion categories should be applied to the standard index. Traditionally, standard indexes are composed of a broad universe and screening on such areas as ESG, among others, takes place in the form of a customised version of the index. The categories of areas that could potentially be applied included: controversial weapons, thermal coal and firearms.

The consensus was that index clients should be provided with as wide a choice of the investment opportunity as possible; applying ESG screens to standard benchmarks at this point in time may not be appropriate yet; however, it could be considered in the future as the views of market participants coalesce.

International Organization of Securities Commission (IOSCO) – Annual Review of Ground Rules

IOSCO is recognised as the global standard setter for the securities sector. It develops, implements and promotes adherence to internationally recognised standards for securities regulation.

As part of the annual process of assessing compliance with respect to the IOSCO principles for Financial Benchmarks Final Report (the IOSCO Principles), the regional equity advisory committees endorsed the past year’s methodology enhancements for FTSE GEIS. The advisory committees confirmed that the rules have been maintained assiduously and continue to meet the purpose for which they were designed. The EMEA equity committee also affirmed the rules for the FTSE UK Index Series. The regional real estate advisory committees endorsed the rules for the FTSE EPRA Nareit Global Real Estate Index Series, and the FTSE Nareit Index Series Advisory Committee endorsed the rules for the FTSE Nareit US Real Estate Indexes.

2. FTSE EPRA Nareit Global Real Estate Index Series

Index Representation of the Asia Pacific Region

Discussions on the representation of the Asia Pacific region in the global index were ongoing. The impetus for this discussion is the small number of large companies that have been removed from the index because of their exposure to property fund management fee income. Property fund management is not regarded as a relevant real estate activity for the purposes of ground rule 4.5 of the FTSE EPRA Nareit Global Real Estate Index Series. However, some investors see property fund management as a growing trend and are reluctant to lose the investment opportunity when such large companies are removed from the index. A number of options were debated by the committee members; all regions being generally in favour of global consistency in the methodology and not being in favour of creating a separate index to accommodate those companies. Analysis will
be conducted over the coming year to determine whether a recognisable trend is being established.

3. Environmental, Social and Governance (ESG)

An ESG Watch List of companies linked to controversies globally is maintained and updated on a quarterly basis. Companies on the Watch List are ineligible for addition to the FTSE4Good Index Series. Those companies assessed with the very highest scores are analysed using the Controversy Monitor framework and are shown to the advisory committee for discussion. At the March meeting, the members provided their comments on companies which had controversies relating to allegations of misleading marketing activities, human rights violations, car emissions and aviation safety.

The committee members commented on proposed amendments to the Controversy Framework, particularly relating to the Exposure indicator on ‘economic or health implications’ and potential refinements to the Exposure indicator for ‘Impact - Scale and severity of the controversy’. FTSE Russell will consider the feedback and provide an update at future meetings.

Consideration was given to the policy for Business Activity Screening for index exclusions. The policy aims to provide definitions on which activities can be screened out of the index for constructing custom indexes. If approved by internal governance the policy is slated for publication on the FTSE Russell website.

The advisory committee affirmed their support for the proposal for FTSE Russell to consider integrating the Transition Pathway Initiative (TPI) scores within the ESG Model. TPI is a global initiative led by asset owners and supported by asset managers. Aimed at investors and free to use, it assesses a company’s preparedness for the transition to a low-carbon economy; hence, supporting efforts to address climate change.

FTSE Russell informed the committee members that it intends to publish a list of categories included within the ‘controversial weapons’ definition. Committee members observed that there is no broad market consensus on what types of weapons should fall within the definition; however, there was agreement that cluster munitions, landmines and chemical & biological weapons are generally considered as controversial weapons.

4. Equity Country Classification

The classification of markets within GEIS is assessed on an ongoing basis and investors are kept fully informed in March on the markets placed on the Watch List and announced to the market in the September Annual Announcement. The Watch List comprises markets under consideration for a possible change in designation between Developed, Advanced Emerging, Secondary Emerging and Frontier market status.

In preparation for the March 2020 Interim Update, the FTSE Country Classification Advisory Committee, the Regional Equity Advisory Committees and the FTSE Russell Policy Advisory Board examined the
progress made by the Watch List markets and considered the classification status of some other markets.

Frequent, pro-active engagement takes place with the individual Watch List markets and involves regulators, stock exchanges and other market authorities. Those meetings are extremely well supported by the Country Classification Advisory Committee members who represent portfolio management, custodial and trading expertise.

Engagement is currently taking place with:

- **Argentina** – possible reclassification from Frontier to Unclassified, subject to capital controls not being removed by 28 September 2020
- **Vietnam** - possible reclassification from Frontier to Secondary Emerging.

Enhancements to the FTSE Country Classification framework, Questionnaire and Quality of Markets (QoM) matrix were published in January. Including:

- Discontinuing the ‘broad market liquidity’ and ‘developed equity market’ criteria.
- Re-introducing a minimum market size requirement.
- Introducing new criteria pertaining to the requirement for a Central Securities Depositary and Central Counterparty Clearing House.
- Restructuring the criterion ‘Custody – Omnibus and segregated account facilities available to international investors’ to ‘Account structure operating at the Custodian level (securities and cash)’.

Further details of the enhancements, effective January 2020, can be found [here](#).

All markets were assessed against the new framework and Quality of Markets criteria ratings and these were published in the [March Interim Update](#).

### 5. Industry Classification

FTSE Russell indexes will transition to new ICB in 2020, starting with the Russell US Indexes at the June 2020 annual reconstitution and following on with FTSE indexes, including GEIS and the UK Index Series, at the September 2020 index review. An FAQ of the index migration timetable can be found [here](#).

At the January meeting, the advisory committee was updated on the work taking place to clarify the process for classifying Collective Investment Schemes (CIS). Committee members welcomed FTSE Russell’s proposal to conduct a market consultation to gain a wider market perspective. The advisory committee will receive a progress report at the next meeting in May.

A proposal to clarify the ground rules regarding the timing of quarterly ICB update announcements for FTSE indexes was endorsed. Following internal governance approval a technical notice was released; see hyperlink: [Industry Classification Benchmark (ICB) (Equity) - Update - Published 6 February 2020](#)

The advisory committee also considered proposed enhancements to the Challenges and Appeals Policy. The committee members endorsed that if a
challenge or appeal results in a change to a company’s ICB classification, FTSE Russell will implement the change with a minimum of two days’ notice. A technical notice of the update was subsequently published; see hyperlink: Challenges and Appeals - Update - Published 2 April 2020

6. Fixed Income

Country Classification
The classification of markets within the FTSE Russell Fixed Income Indexes is assessed on an ongoing basis and investors are kept fully informed in March on the markets placed on the Watch List and announced to the market in the September Annual Announcement. The Watch List comprises markets under consideration for a possible change in Market Accessibility Level.

In preparation for the March 2020 Interim Update, the Regional Fixed Income Advisory Committees and the Policy Advisory Board examined the progress made by the markets included on the Watch List since September 2019.

Engagement is currently taking place with:

- **Malaysia** – possible reclassification from Market Accessibility Level 2 to 1
- **China** – possible reclassification from Market Accessibility Level 1 to 2

Following consideration of the feedback received from the advisory committees, FTSE Russell released the March Interim Update which can be found here: FTSE Fixed Income Country Classification - Interim Update

Additionally, at the March meetings the APAC & EMEA regional committees were consulted on proposed methodology changes covering the inclusion of linkers to the framework, the definition of what constitutes an Emerging Markets, cash reinvestment in the index return calculations, review of the index credit rating methodology, index eligibility for dual currency bonds, index snap time, and methodology clarifications for WGBI (the World Government Bond Index, called bond handling, the index holiday calendar and issuer classifications). FTSE Russell will continue to review these areas via the internal governance process.

March 2020 Month-End Rebalances
Extensive client consultation took place on whether FTSE Russell should continue or suspend the March month-end rebalance for WGBI and EMGBI (Emerging Markets Government Bond Index) because of the volatile market activity resulting from the Coronavirus COVID-19 pandemic.

FTSE Russell examined the feedback and decided that the volatile market conditions amounted to a market disruption event. A notice informing the market of this decision was duly published; see hyperlinks: FTSE Fixed Income Indexes to Postpone March 2020 Month-End Rebalances - Published 23 March 2020 & Additional Details - Published 25 March 2020
Members of the US Fixed Income Advisory Committee shared their views on the decision taken by FTSE Russell. Some members queried the circumstances under which FTSE Russell would take a decision to suspend a month-end rebalance to better understand when this could potentially take place in the future. Any future decision to postpone a rebalance would be based on consultation with clients, regulators, central banks and other index stakeholders. Some stakeholders shared their opposition to the suspension decision; however, others commended FTSE Russell for taking the decision to pause the rebalance and that it was implemented without any operational glitches.
About FTSE Russell

FTSE Russell is a leading global index provider creating and managing a wide range of indexes, data and analytic solutions to meet client needs across asset classes, style and strategies. Covering 98% of the investable market, FTSE Russell indexes offer a true picture of global markets, combined with the specialist knowledge gained from developing local benchmarks around the world.

FTSE Russell index expertise and products are used extensively by institutional and retail investors globally. For over 30 years, leading asset owners, asset managers, ETF providers and investment banks have chosen FTSE Russell indexes to benchmark their investment performance and create investment funds, ETFs, structured products and index-based derivatives. FTSE Russell indexes also provide clients with tools for asset allocation, investment strategy analysis and risk management.

A core set of universal principles guides FTSE Russell index design and management: a transparent rules-based methodology is informed by independent committees of leading market participants. FTSE Russell is focused on index innovation and customer partnership applying the highest industry standards and embracing the IOSCO Principles. FTSE Russell is wholly owned by London Stock Exchange Group.

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