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Steering capital: the growing private authority of index providers in the age of passive asset management

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Abstract

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index providers are becoming gatekeepers that exert de facto regulatory power and thus may have important effects on corporate governance and the economic policies of countries.

Conclusion: a research agenda for index providers

Keywords: private authority index providers stock market indices passive asset management index funds capital flows

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The period after the global financial crisis has been characterized as the ‘age of asset management’ (Haldane, [2014](#)) as banks bore the brunt of new international regulation and asset managers consequently emerged as more important than ever before. However, it is not asset management in general that is burgeoning in this new post-crisis era. Actively managed funds where (highly paid) managers pick stocks with the aim of ‘beating’ the market are declining, while ‘passive’ investing is growing rapidly. Through index mutual funds and exchange traded funds (ETFs), both of which carry extremely low fees for investors, passive asset managers replicate established stock market indices such as the S&P 500, the FTSE 100 or the MSCI World. This fundamental shift in investor behavior towards passive strategies has pronounced implications for corporate governance, corporate power, and market competition (Azar, Schmalz & Tecu, [2018](#); Braun, [2016](#); Elhauge, [2016](#); Fichtner, Heemskerk & Garcia-Bernardo, [2017](#); Haberly, MacDonald-Korth, Urban & Wojcik, [2019](#); Jahnke, [2019b](#)). We add to this

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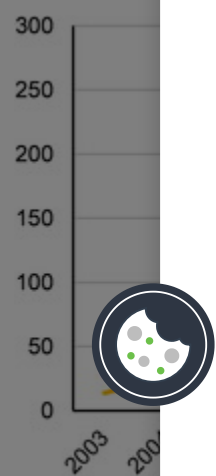
funds are unable to beat broad market indices over longer time periods but charge high fees. In mid-2019, the assets of US equity index funds have surpassed active funds (Gittelsohn, 2019). Hence, we have entered the age of passive asset management. One crucial, yet largely unstudied element of this new era is that index funds effectively delegate their investment decisions to index providers. Index providers are the firms that create and maintain the indices on which passive funds rely and to which asset managers have to pay fees if they use them.

Additional information

Similar to passive asset management, which is dominated by the 'Big Three' of BlackRock, Vanguard, and State Street (Fichtner et al., 2017), the global index provider industry is very concentrated. Just three firms, MSCI, S&P Dow Jones Indices (DJI) and FTSE Russell, hold a combined market share of almost 80% (Burton-Taylor, 2018). While global index revenues totaled a record US\$2.7 billion in 2017, their profit margins that stand out as exceptionally high. MSCI reports an operating margin of over 60% for its index segment in 2018 (MSCI, 2019). This suggests that index providers operate in an oligopolistic industry, which has high barriers to competition. Figure 1 shows the growth of index providers in the dawning age of passive investing. Both MSCI and FTSE (excluding Russell) doubled their revenues from 2006 to 2010. From 2010 to 2017 FTSE and S&P DJI increased their revenues by over 150%. Hence, during the last decade the big index providers have had much higher growth than most other financial companies, especially banks.

Figure 1. Revenues of the three big index providers (2010 = 100).

Source: Orbis and annual reports



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Wigglesworth (2019b) emphasizes that ‘financial indices are arguably the most under-appreciated force shaping global markets’. Remarkably, however, as Rauterberg and Verstein (2013, p. 105) note, scholars ‘have largely ignored the indispensable role indices play in markets’ – notwithstanding some important work by finance and law scholars (Rauterberg & Verstein, 2013; Robertson, 2019a, 2019b). We aim to fill this void through a first analysis of index providers from an IPE perspective. We argue that index providers today occupy a position of growing private authority, with decision-making and standard-setting capabilities that are consequential in the global political economy. In the past, their indices primarily served informational purposes. An index such as the S&P 500 or the Nikkei was primarily a numerical representation of a particular stock market. Indices served as benchmarks against which analysts could gauge the performance of stocks. While the decisions of index providers had some impact on actively managed funds, the rise of passive investing transformed their role in a significant way. Today, they de facto steer capital with their indices as inclusions of firms or countries to an index can lead to inflows of billions of US\$ while exclusions can cause large quasi-automatic outflows. Constructing indices is therefore not a purely technical exercise. Index providers have significant discretion in devising their methodologies. Robertson (2019b), for instance, finds that the methodology of the pivotal S&P 500 index was changed at least eight times between 2015 and 2018. Underlying their seemingly technical exercise are decisional discretion and normative assumptions about ‘good’ corporate governance and ‘free’ markets. Index providers therefore play a role as standard-setters: their notions on what constitutes good corporate governance at the level of the firm and a favorable investment environment at the level of the market are consequential in the global political economy. This is particularly true in the context of contracting capital, where the combination of index providers’ discretion and the growing influence of passive investing has transformed the global financial landscape. In 2018, the Anglo-American headquarter of the interest of shareholders based

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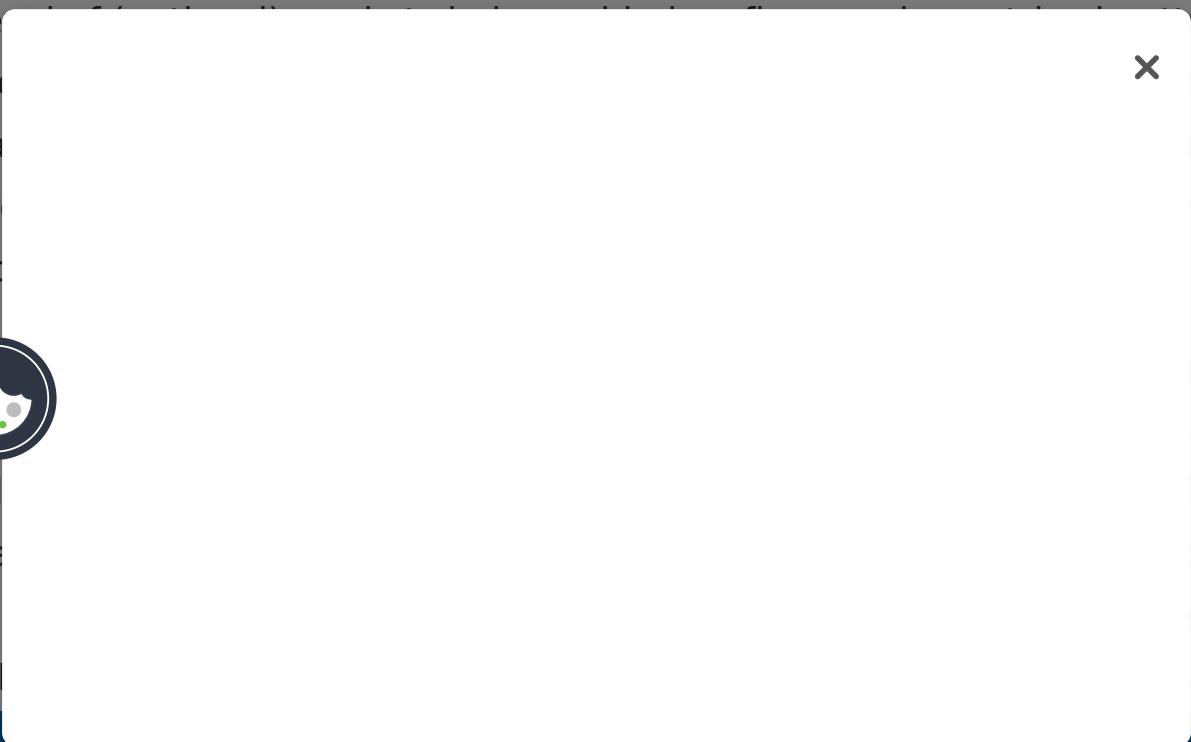
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of its index methodology. Investors opposed this as they would have been forced to sell the stock, index funds because they directly track the FTSE 100 and active funds because they are benchmarked against this key British index (Wood, [2018](#)). Thus, in the age of passive investing membership in a benchmark index takes strategic precedence over other shareholder interests. A second example illustrates how index providers have become relevant actors in the global political economy. In 2015, the finance minister of Peru hurriedly travelled to New York because of rumors that MSCI might downgrade the country from its flagship 'emerging markets' stock index to 'frontier' status (Alloway, Burger, & Evans, [2017](#)). Eventually Peru managed to escape this fate by changing financial market regulations and engaging in 'roadshows with institutional investors to identify what were the necessary measures to strengthen liquidity and implement them' (Doll, [2019](#)). Today index providers have become important counterparts for states.

In what follows we develop the argument that index providers increasingly are to equity markets what credit rating agencies are to bond markets, crucial 'coordination service firms' that exercise private authority and effectively set standards for the behavior of other firms and even countries (see Cutler, Haufler, & Porter, [1999](#); Nölke & Perry, [2007](#)). Their new authority was not delegated from the public sphere, but gradually emerged as part of a transformation of the index provider industry – from primarily supplying information about markets to becoming private authorities that are able to set standards on corporate governance and steer international capital flows. Take for example FTSE Russell, S&P DJI and MSCI's emerging market indices; the index providers' recent decision to include countries such as China and Saudi Arabia to their

indices in order to attract passive investment. We analyze this process using semi-structured expert interviews between direct quotes to conceptualize and three authority discourses in the global political economy as 13 conducted information and authority in order to section two providers to and five setting role

states through steering capital flows. The final section concludes by developing a research agenda on index providers.

Introduction

Indices, index providers, and private authority

Conclusion: a research agenda for Index providers

Indices are numerical tools that enable the comparative evaluation of groups of assets over time. The purpose of indices is to display the performance of a specific economic entity such as a nation's stock market (S&P 500) or the rate at which banks offer to lend to each other (LIBOR) in one single number that is relatively easy to understand and comparable over time. As such they consist of a series of corresponding dates and numbers, evaluations based on a series of assets (e.g. stock prices) with specific weightings, whose sequence depicts the performance of the evaluated assets (Robertson, [2019a](#)). Thereby, indices demarcate the boundaries of what these entities are: the 500 companies that the S&P 500 evaluates are (perceived as being) synonymous with the US stock market.

Political economy research on such financial market indices is limited and mostly focused on LIBOR, often dubbed 'the world's most important number', which attracted a lot of attention after it became clear that banks had colluded to manipulate it (Stenfors & Lindo, [2018](#)). Others have focused on the emergence of the ABX index in subprime-mortgage markets (MacKenzie, [2012](#)) or the creation of index-based financial derivatives (Millo, [2007](#)). Some scholars have focused on emerging market bond indices (Blustein, [2006](#); Hardie, [2006](#); Santiso, [2003](#)). Blustein ([2006](#)) emphasized how index calculations can create 'perverse' incentives as index weightings are determined by existing levels of debt. Santiso ([2003](#)) outlined the importance of indices in emerging

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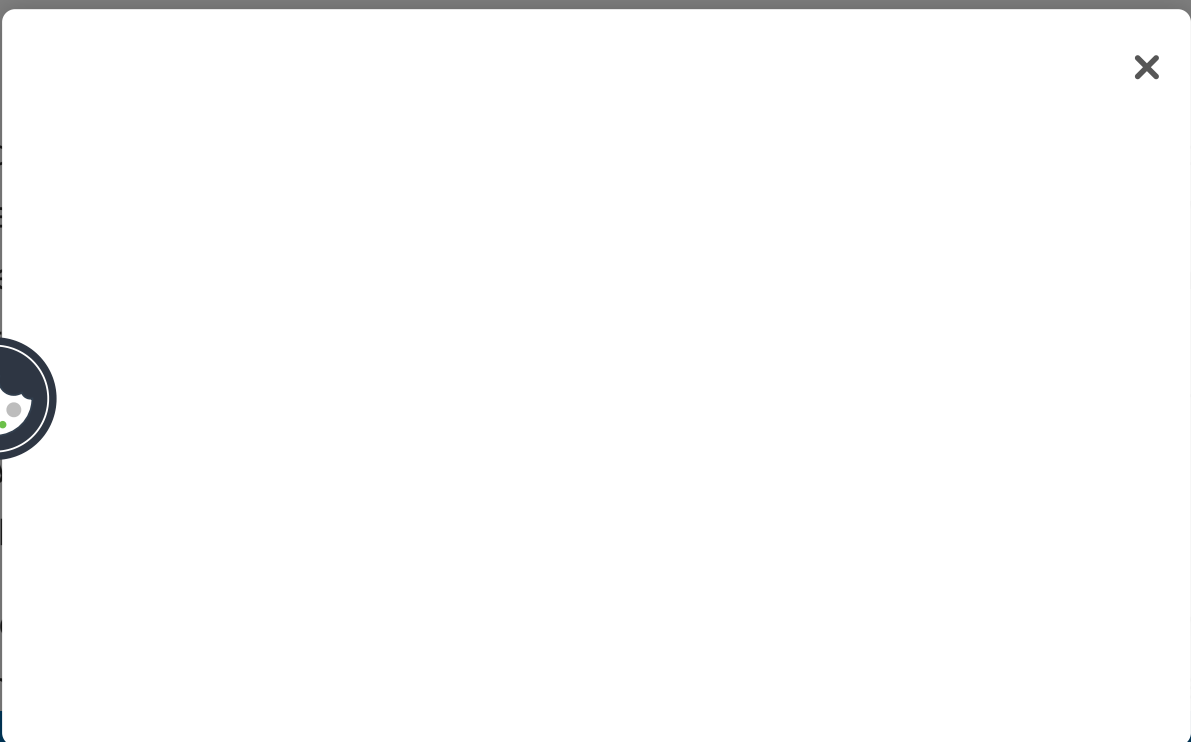
Introduction But financial market indices are far from objective. The 'vener of numerical representation' (Broome & Quirk, [2015a](#), p. 829) conceals the normative values and assumptions underlying their calculation. They represent 'deliberate decisions' made by index providers as every index is a managed portfolio whose composition is decided by the respective index provider (Robertson, [2019a](#)). Thus, while these simplified numerical representations might seem objective and technical, they are actually based on complex and (often contested) normative values. Moreover, processes of index production are inherently subjective activities, '[as] human discretion and value judgement are essential ingredients in even the most "objective" indices' (Rauterberg & Verstein, [2013](#), p. 101). As Büthe & Mattli ([2011](#), p. 11) stress, standard-setting is always political.

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The political underpinnings of numerical tools such as indices, indicators and benchmarks have received growing attention (Broome & Quirk, [2015a](#), [2015b](#); Cooley & Snyder, [2015](#)). This emerging literature underscores how indices and indicators have a governing effect on those that are being evaluated, incentivizing the individuals, companies or states that are being assessed to comply with the norms underlying those numerical representations, as better performance has positive ideational and material effects, enabling a form of 'governance from a distance' (Broome & Quirk, [2015a](#)). The most prominent example of such numerical evaluation measures in global finance are credit rating agencies which can shift the asset allocation of billions of US\$

by up- or downgrading. Sinclair, [2010](#); index and ment- We argue singly (Alloway et al., [2010](#)); providers are the actors et al. ([1999](#),



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individual or organization has decision-making power over a particular issue area and is regarded as exercising that power legitimately' and who 'develop and enforce binding obligations [...] often for [an] industry as a whole'. A useful distinction is between actors that are 'in authority' such as state officials or private actors who receive delegated authority and those that are 'an authority': a position derived from their positioning as experts within a given social structure (Lincoln, [1994](#); Sinclair, [2005](#)). Index providers, we argue, are 'an authority' and their relevant social structure is the international investment community. In IPE a literature has developed on the emergence of authority beyond the public realm (Cutler et al., [1999](#); Hall & Biersteker, [2002](#); Kahler & Lake, [2003](#); see Büthe [2004](#), [2010](#) for overviews). This literature has analyzed the interplay between public and private authorities as well as the emergence of private authority through the retreat of the state, which provided a space for private actors such as firms to exercise authority (Cutler et al., [1999](#)).² We are particularly interested in the growing private authority that index providers now have in the investment community, and furthermore how they have grown into such a position of private authority. This leaves aside other - obviously relevant - questions such as the public regulation of index providers. We come back to these issues in our concluding research agenda. In what follows we seek to establish the source(s) of their legitimacy and authority. As Lake ([2010](#)) notes, private authority is inherently relational, produced and reproduced through ongoing interactions between the authority and non-authorities, where the formers' decisions are considered as legitimate by the latter (see also Büthe, [2010](#)). Rather than coercion or self-interest, legitimacy is a 'normative belief by an actor that a rule or institution ought to be obeyed' and is based on how the authority

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2005) – and this reputation is embodied by each of the three big index providers’ brands. Like the brand of one of the large credit rating agencies, ‘all it has is an intangible reputation for good judgment’ (Sinclair, 2019, p. 11). It is their brand why investors follow the major index providers’ decisions, and which makes these so consequential. As several interviewees noted, the big three index providers are ‘brand managers’ (Interviews 9-10), and: ‘at the end of the day, those products are homogeneous and exchangeable. It’s like water, there are small differences why Evian is more expensive [...]. Those are minimal differences, but the price tags are very different! [...] MSCI is famous for being expensive – not because they have better data or indices, but because they are the brand that is most used in the world [...] Brand is everything!’ (Interview 7). Another interviewee adds, ‘the brands matter: it’s like drinking Coca-Cola, you could drink Dr. Pepper or Pepsi-Cola, but [investors] prefer Coca-Cola’ (Interview 10). While intellectual property rights do not apply to index methodologies, index provider ‘brand names’ are protected (Interviews 9, 11). Like rating agencies, their brands give the large index providers ‘a hold on collective thinking’ (Sinclair, 2019, p. 11) that other index providers do not enjoy.

A third condition that underpins index provider authority lies in a set of network externalities that reinforce the authority of the major index providers. As first movers they have in effect ‘captured’ different national (e.g. S&P 500 or FTSE 100) and regional (Euro Stoxx 50) market segments with their indices (Interviews 10, 12). There is no need for dozens of numerical representations of an economic entity, because liquidity tends to concentrate in only a few products (Interview 11). Moreover, investors have created performance track records with these established benchmarks, which makes it

difficult to displace them. This is particularly true for the ‘index families’, of major global indices (Interview 12). These indices that increase liquidity (Interview 12). These indices derive from their network externalities and some private authority.

Notably, the authority of these indices is specific (historical) and they gain authority of rating agencies.



credit, which created a demand for rating agencies' services for the functioning of the then disintermediated structure of finance. Therefore, 'authority is best understood as an effect of these circumstances, rather than as an entity or a characteristic of an actor or institution' and its existence is therefore not functional, [...] but always contingent on time, place, and circumstance' (Sinclair [2005](#), p. 64). In the following sections we substantiate how the authority of index providers has shifted from minimal and relatively insignificant to sizable and consequential. Historically, they were primarily providers of information. But with the ongoing shift towards passive asset management, index providers became de facto market authorities because their brands – i.e. their indices – became central building blocks for the functioning of index funds. As a result, their decision-making capabilities on index composition have direct effects on steering capital flows.

The naissance of the index provider industry

Initially, index providers were part of the financial media complex. While their expertise was already developing, they were no authorities in capital markets but part of the machinery that provided information for investors – indices were 'a news item' (Interview 12). They were helpful but arguably not essential for investment decisions. Indices were published in newspapers to provide investors with information about the American post-civil war railroad boom. Charles Dow who in 1896 developed the Dow Jones Industrial Average, the world's first financial market index, also created The Wall Street Journal. Similarly, the Financial Times created indices for the London stock market since 1935 and the Japanese Nikkei newspaper for the Tokyo market since 1949.

The preceding company (now Standard & Poor's) was founded in 1966, until the late 1990s. Next to the only natural as it was es such as Nasd were created in col he Financial Times (F joint venture ck Exchange in 1997, nd Dow Jones. R ne

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non-US equity markets, which were licensed by Morgan Stanley in 1986 under the name Morgan Stanley Capital International (MSCI) indices. In 1998, MSCI was established as a joint venture between Morgan Stanley and Capital International. Originally, indices were calculated daily or weekly and published in newspapers to inform about market movements. This process was accelerated with the advent of modern information technology that led to the digitization of markets and index providers started calculating indices in real time. Indices were soon displayed on stock exchanges' trading floors, daily news reporting was conducted in front of these charts, and indices became synonymous with 'the market'. With the shift in global finance from banks to capital markets indices became more relevant as information tools tracking the development of financial markets (Campbell-Verduyn, [2017](#)). First, this led to the emergence of a few indices as recognized benchmarks by those index providers that had positioned themselves to 'provide the right concept at the right time for the market' (Interview 10). Second, investors wanted to compare performance between markets in a transparent and trustworthy manner. This gave rise to globally comparable indices for instance by MSCI, which 'investors really like because you can separate the globe into individual, comparable pieces' (Interview 7). Further, in the 1980s exchanges such as CME and LIFFE started launching index futures and options, gradually increasing their importance as reference prices for underlying assets (Millo, [2007](#)).

In the era of active investing indices were 'helpful' but not 'essential' to the functioning of financial markets. A few index providers enjoyed considerable brand recognition, some indices were synonymous to the markets they aimed to represent, and index futures e...ely managed funds us...ices had at least som... index could be conce... loosely anchored... choose both the dec... as one inter...gement was to be di...ne decision-making... relatively limited i... time, the main fur... their exact compo... This

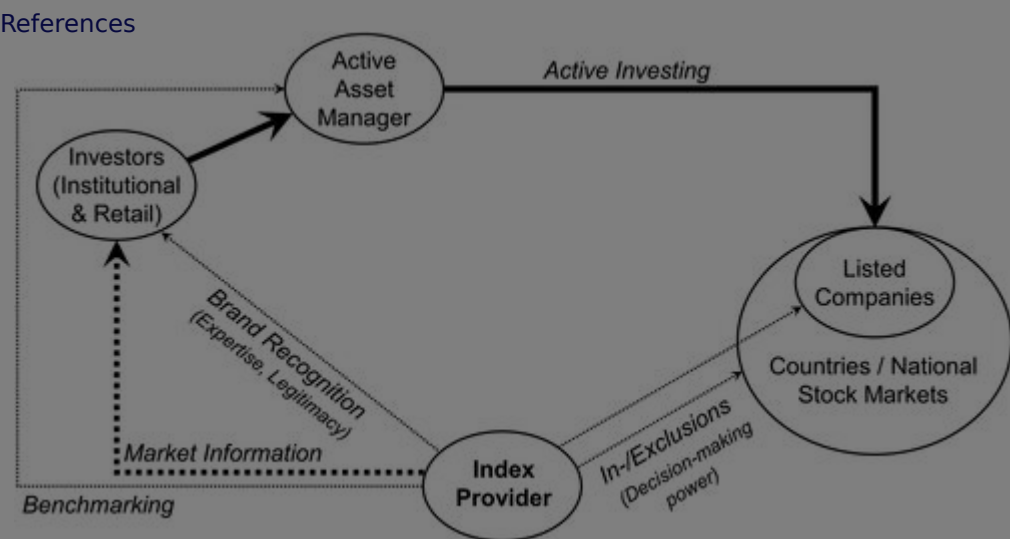


providers began to influence capital flows in an immediate and comprehensive way. Being a central component of the index funds ecosystem conferred them – gradually and only as a side-effect of their business model – a position of growing private authority in financial markets.

Figure 2. The role of index providers before the shift to passive investing.

Note: Dotted lines represent non-monetary relations; solid lines constitute monetary flows.

Source: Own illustration.



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From supplying information to exerting authority

The financial crisis triggered two reinforcing trends that transformed index providers

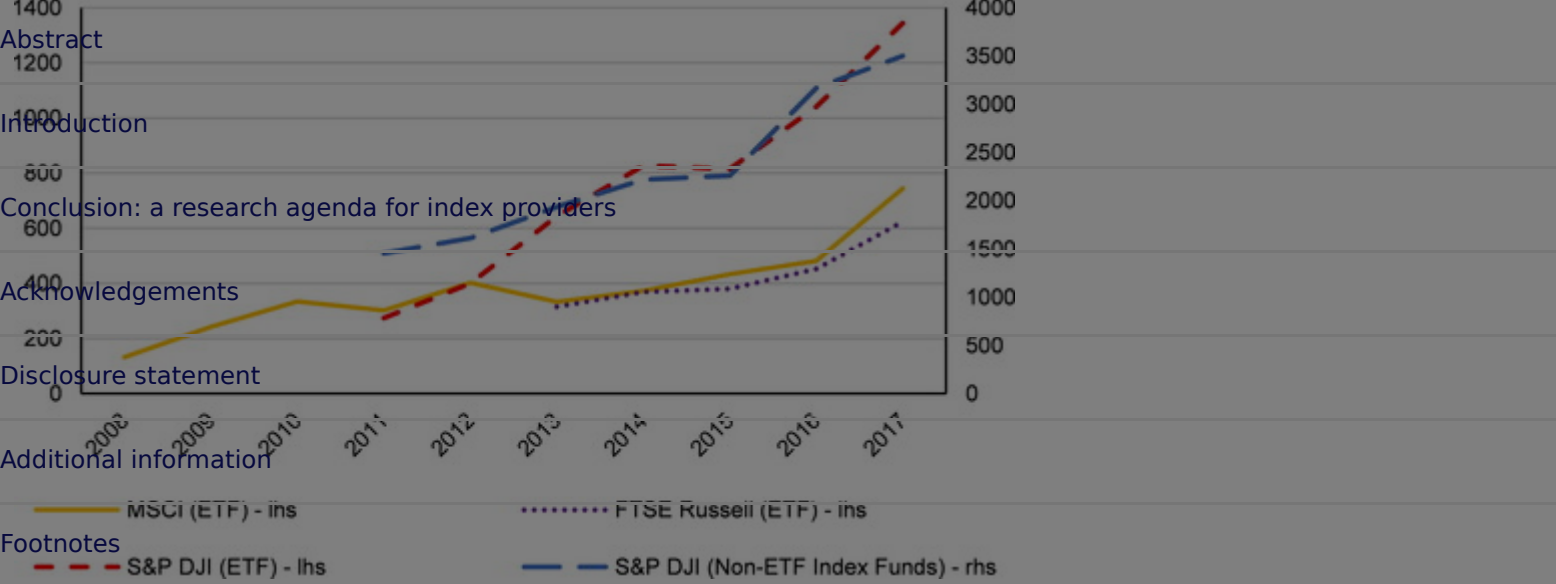
from mere information suppliers to active market participants. The index industry's growth was well established, with the FTSE 100 and the London Stock Exchange (LSE) having a market cap of over £1 trillion. The industry was also becoming more global, with the FTSE Global Index accounting for 73% of the index industry's assets under management. The industry's influence was also growing, with the FTSE 100 being used as a benchmark for various financial products. The industry's growth was also driven by the increasing demand for index funds, which were seen as a way to diversify investments across a wide range of companies and industries. The industry's growth was also driven by the increasing demand for index funds, which were seen as a way to diversify investments across a wide range of companies and industries. The industry's growth was also driven by the increasing demand for index funds, which were seen as a way to diversify investments across a wide range of companies and industries.

The second and more consequential trend was the money mass-migration towards passive investments, which significantly increased the nascent authority of index providers as evermore funds directly tracked their indices. Whereas in the past indices only loosely anchored fund holdings around a baseline, now they had an instant, 'mechanic' effect on the holdings of passive funds, 'steering' capital flows. Increasingly, investments were not actively managed by fund managers but passively invested into index mutual funds and ETFs (Braun, 2016; Fichtner et al., 2017; Haberly et al., 2019; Janike, 2019b). This makes sense as the vast majority of actively managed funds have not been able to beat benchmark indices over longer periods of time, while charging substantially higher fees than index funds (SPIVA, 2019). In order to track the performance of 'the market', passively managed funds replicate stock market indices such as the S&P 500 or the MSCI World. Rather than trying to generate 'alpha' and outperform the market by picking stocks, these passively managed funds aim to generate 'beta', simply replicating the performance of specific stock markets while minimizing fees. Figure 3 shows the development of assets indexed to indices from the big three index providers, both for ETFs (scale left hand side) and non-ETF index funds (scale right hand side). ETFs indexed to MSCI indices increased more than fivefold between 2008 and 2017, from US\$132 billion to US\$744 billion. Similarly, ETF assets tracking FTSE Russell indices doubled from 2013 to 2017. From 2011 to 2017 assets indexed to S&P DJI indices quintupled from US\$274 billion to US\$1,344 billion, while non-ETF assets (mainly Vanguard US index mutual funds) increased from US\$1,456 billion to a staggering US\$3,500 billion. Notably, passive investing is further advanced in equities than in bonds as equities are much more standardized and liquid. However, in recent years, the growth of passive investing has also been seen in 2019 fixed-income

Figure 3.

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By investing in an index, passive investors delegate decision-making about where to invest to index providers. Index investing thus represents a form of ‘delegated management’ and every discretionary decision by index providers has a ‘flow through effect on the investor’s portfolio’ (Robertson, [2019a](#), p. 843). As Howard Marks of Oaktree Capital stated: ‘somebody is making very active decisions about which stocks will be in each “passive” product. [...] the people who create the indices are deciding which stocks will be invested in’ (Alloway et al., [2017](#)). Index providers steer these giant passive investment capital flows. But index providers have a steering effect over active managed funds as well. Established and well-known indices are increasingly used as direct benchmarks by actively managed funds which measure their performance against these indices, and which thus are crucial as investment baselines.

Benchmarking against indices has reached enormous proportions: US\$14.8 trillion, US\$16 trillion, and US\$18 trillion. This is marked by the fact that the S&P 500 index is used as a benchmark by 70% of actively managed funds. This is a significant increase from 2002, when only 15% of actively managed funds used the S&P 500 as a benchmark. The rise of passive investment has also led to a significant increase in the number of index funds. In 2002, there were only a few index funds, but by 2017, the number had grown to over 1,000. This growth is driven by the fact that index funds are generally less expensive than actively managed funds, and they have performed well over the long term. The rise of passive investment has also led to a significant increase in the number of index providers. In 2002, there were only a few index providers, but by 2017, the number had grown to over 100. This growth is driven by the fact that index providers are able to offer a wide range of index funds, and they are able to attract a large amount of capital. The rise of passive investment has also led to a significant increase in the number of index funds. In 2002, there were only a few index funds, but by 2017, the number had grown to over 1,000. This growth is driven by the fact that index funds are generally less expensive than actively managed funds, and they have performed well over the long term.



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shift their investment according to reclassifications by index providers, but also active funds that are benchmarked against established indices.

The degree to which types of institutional investors delegate their investment decisions to index providers varies. Table 1 shows this variation across two different dimensions: the degree of index replication and the time period for doing so. Hedge funds and sovereign wealth funds (SWFs) generally have low degrees of replicating indices (one exception is the Norwegian SWF, which almost invests like a global ESG⁵ index fund) and are fully discretionary to follow any index modification. Many actively managed mutual funds replicate their benchmark indices to a certain degree, and some will likely follow if the index constituents change. In other words, for them the index acts as a loose anchor from which they will not totally deviate but which they will also not fully and immediately follow. Closet index funds are shown for the sake of completeness; they approximate passive funds but charge higher fees. Finally, ETFs and index mutual funds fully replicate the tracked index and generally do so immediately.⁶ This absolute reproduction of the asset allocation as decided by index providers – what we call steering capital – is the crucial difference to actively managed mutual funds. And, we argue, this is a qualitatively new development that necessitates research on the kind of authority that index providers wield.

Table 1. Relationship between index providers and types of investors.

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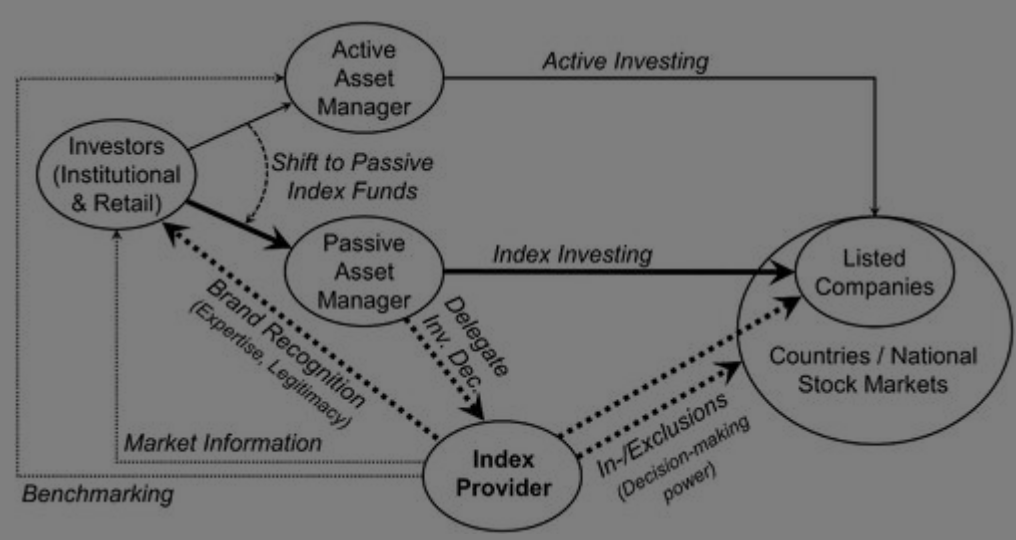


exclusions of companies or countries index providers are effectively steering capital. Or, in the words of Authers (2018): 'indices no longer merely measure markets. They move them.' This role as critical gatekeepers that decide the criteria for index membership confers MSCI, S&P DJI and FTSE Russell with growing private authority as they set the standards that firms and states have to follow if they seek inclusion in key indices.

Figure 4. The role of index providers after the shift to passive investing.

Note: Dotted lines represent non-monetary relations; solid lines constitute monetary flows.

Source: Own illustration.



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benchmarks as underlyings, which enables risk management and increases liquidity. As
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discussed, liquidity is often concentrated in a few benchmarks (interview 10).
Furthermore, the major index providers have accumulated a lot of data and acquired
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related businesses (e.g. MSCI's acquisitions of Barra and RiskMetrics), that makes it
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very difficult and costly to switch (Interviews 9-11). All of that creates a 'virtuous circle'
for the big index providers that thus benefit from 'a historical legacy for providing the
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right concept at the right time for the market' (Interview 10). Therefore, while some
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competition in the index industry exists, 'catching up organically is impossible'
(Interview 11) and newcomers do not have 'the brand, the history and the assets
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attached to that' (Interview 9) - the conditions which provide the established index
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providers with the authority to move markets.

Consequently, the large index providers have become private authorities that move markets. This movement of markets works in two related but different ways. First, index providers have an increased authority as standard-setters in corporate governance. Even when they adhere to minimal standards for firm inclusion into their indices, their influence is considerable. This kind of standard-setting authority is especially pronounced in the developed markets of Europe and North America. Second, their decision-making power is even more consequential when we consider emerging markets. Index providers not only decide to include particular firms, they also make decisions on in- and exclusions of entire markets, steering capital with important politico-economic implications for states.

Setting standards: promoting 'good' corporate governance?

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by Deutsche Telekom, joined the S&P 500 (Bary, [2019](#)); presumably the aim was to increase the representativity of the index (interview 9). So, while the majority of inclusions is rather mechanical and influence is indirect, it is not uncommon that index decisions target individual firms to set a 'precedence' on a particular issue that then gets incorporated into existing methodologies (Interviews 9-10). One such example is Snap Inc., which wanted to publicly offer shares without any voting rights. After protest by institutional investors the big three index providers initiated a consultation process and eventually announced that at least 5% voting rights have to be offered to public shareholders for a company to qualify for index membership (Hall, Kaplan & Polk, [2017](#)). In addition, S&P DJI and FTSE Russell decided that they will exclude firms that have multiple types of shares with disparate voting rights. FTSE Russell ([2017](#), p. 6) used relatively strong words in its voting rights consultation: 'The proposal set out here effectively draws a principled line in the sand.' However, the low value of 5% shows that the index provider pursues a cautious approach. Moreover, the exclusion of companies that have very unequal classes of stock does not pertain to existing well-known index members such as Alphabet (i.e. Google), Berkshire Hathaway or Facebook (Jahnke, [2019a](#)).

Another aspect that demonstrates the far-reaching yet hidden politico-economic consequences of index methodology is that members of the S&P 500 - the index that like no other epitomizes the American stock market - are allowed to be legally based outside the US in a few selected 'domiciles of convenience' (S&P DJI, [2019](#)). These domiciles include jurisdictions that have been identified as 'sink' offshore financial centers (OFCs), such as Bermuda, the Cayman Islands and Jersey, which provide low or

zero tax as Ireland and Switzerland. Currently 20 member states of the EU could in effect be used for tax evasion.

There are also interesting effects on companies. For example, in 2000 Microsoft had 2000 member companies in its index. The realization, which means an adjustment, was estimated to be 5% while

however, penalizes firms that have long-term blockholders, which could be companies in which the state holds significant ownership (France) or corporations in which founding families hold large blockholdings (Germany). It induces an incentive for listed companies to reduce long-term blockholders, thus facilitating institutional change in these political economies (see Deeg, [2009](#); Fichtner, [2015](#)). Moreover, it has become standard practice for the majority of key global stock indices to use only the market capitalization of firms for calculating the weight of companies. Market capitalization primarily derives from the (future) profits of corporations. Even though that has changed somewhat in the last decades, profit maximization is still not the exclusive goal of corporations from countries such as France, Germany and Japan. Passive asset managers (e.g. BlackRock), even when quasi-permanently holding large ownership positions, are not excluded from the calculation, however.

How should we think about the influence that index providers now have in the area of corporate governance? The historical *raison d'être* of index providers was to provide accurate representations of stock markets (Interview 10). Therefore, among the top objectives of index providers is to maximize the representativity of their indices and to minimize turnover of index constituents. Mark Makepeace of FTSE Russell stated: 'We're not activists. We're setting the minimum standards that investors generally will accept, and our role is to build consensus amongst that investor community as to what that minimum standard should be' (Alloway et al., [2017](#)). Hirst & Kastiel ([2019](#), pp. 14-15) have characterized index providers as 'reluctant regulators' that, because of their business model, have a 'structural incentive to follow the preferences of investors', which leads them to prefer broad coverage of their indices - arguably this makes index

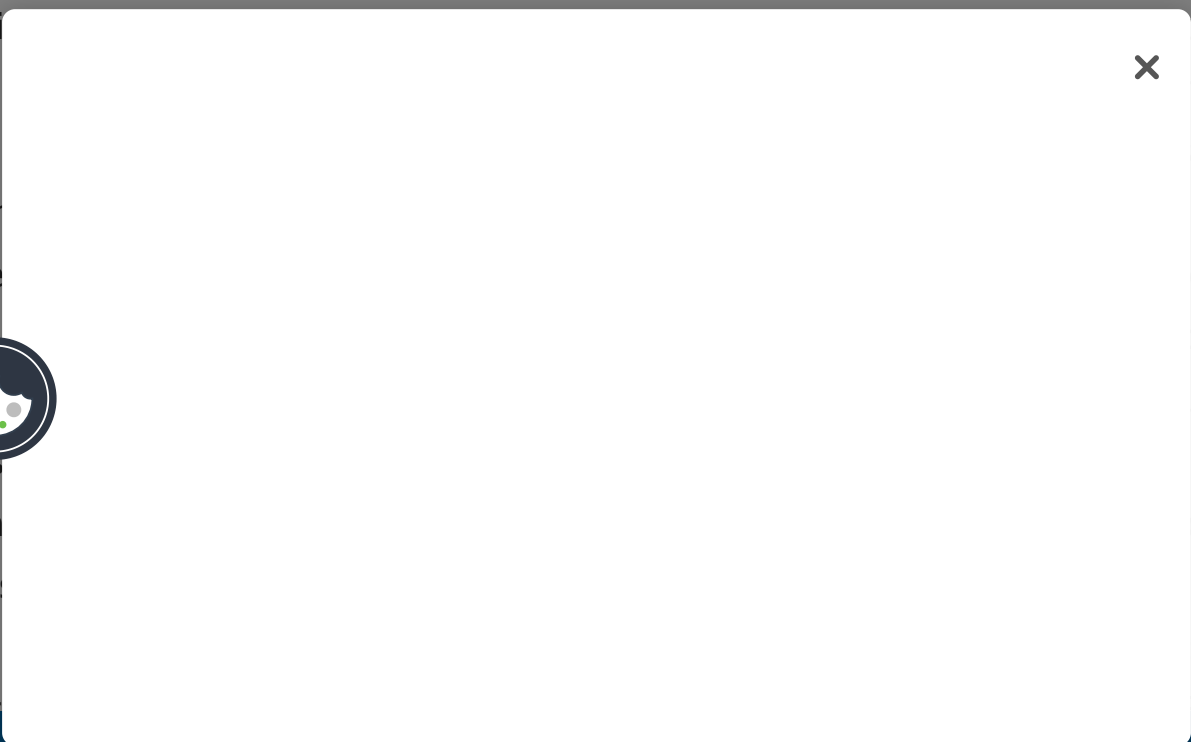
exclusion of big index providers to date their own interests mainly from Anglo-American investors. Whereas the position of index providers is their central standard to private regulators, reluctant assess individuals. Thus, more respect

Steering capital: promoting 'free' and accessible markets?

Abstract

Perhaps the most significant consequence of recent changes in the index provider industry from an IPE perspective is that they have become influential private actors vis-à-vis states, especially emerging economies. While indices are comprised of the stocks of individual companies, each of these companies is listed on an exchange, which is situated within a country that creates the rules and regulatory frameworks for its national stock market. These rules that states decide upon, however, do not necessarily match the preferences of index providers. A large literature exists on the role of (international) investors and their power versus states (e.g. Babic, Fichtner, & Heemskerk, [2017](#); Bortz & Kaltenbrunner, [2018](#)). We argue that in the age of passive investing this power is partially transferred to index providers as they decide over capital inflows/outflows through inclusions/exclusions. This is especially relevant for emerging economies as financial markets are organized hierarchically and emerging countries bear the brunt of skittish investor behavior (Kaltenbrunner, [2018](#)). The dynamics of this process are changing, however. Through index investing the active investment decision to enter or exit markets has been delegated to index providers and their seemingly 'technical' criteria; as one index provider noted 'we look at country classification just as a mechanical tool to access markets' (Interview 12). By reclassifying individual countries, index providers effectively redraw the borders of markets. Index providers set out the criteria that decide which countries are 'investment-worthy', thereby defining this very hierarchy.

For developing countries, on the other hand, being part of an index is important as international stock markets, not only international and profile. I and establish my (Interview economy the no 1 to attract but as argued above, s mptions about th onal investor global finance. es and whether 2v



reclassifications, index providers create incentives for states to comply with their rules.

As one interviewee put it: ‘the big index providers, they are setting standards! [...]

Before, nobody paid attention, but now so much money follows them, [...] they have a

lot of political power!’ (Interview 5).

While S&P DJI is the world’s largest index provider by revenue, this is mainly due to the

crucial S&P 500 index. In contrast, MSCI is the largest provider for emerging markets

equity indices (Miyajima & Shim, [2014](#)). In the words of the Financial Times, ‘MSCI [...]

in effect controls the definition of which countries are “emerging markets”’ (Authers,

[2018](#)).⁹ Therefore, MSCI’s criteria for inclusion/exclusion are crucial for emerging

markets. MSCI’s CEO even states that ‘there’s not a country that doesn’t call as soon as

a review is announced’ (Wigglesworth, [2019a](#)). These criteria are set out in MSCI’s

Market Classification Framework, comprising three elements: economic development;

size and liquidity; and investor access. Economic development is not crucial as a

criterion, neither are the size and liquidity requirements (only 2-5 companies need to

meet minimum requirements). Investor access is the dealmaker/breaker for country

classifications, and it is on this that most indexing decisions are based (Interview 13).

As MSCI ([2018a](#), p. 2) states, the criterion of market accessibility ‘aims to reflect

international institutional investors’ experience of investing in a given market’, and its

assessment is ‘based on qualitative measures’ that MSCI reviews for all markets at

least once a year during its Global Market Accessibility Review. This provides MSCI with

a great degree of discretion and ‘ample space for subjective judgement on whether

certain countries should be considered frontier or emerging markets’ (Moreolo, [2018](#));

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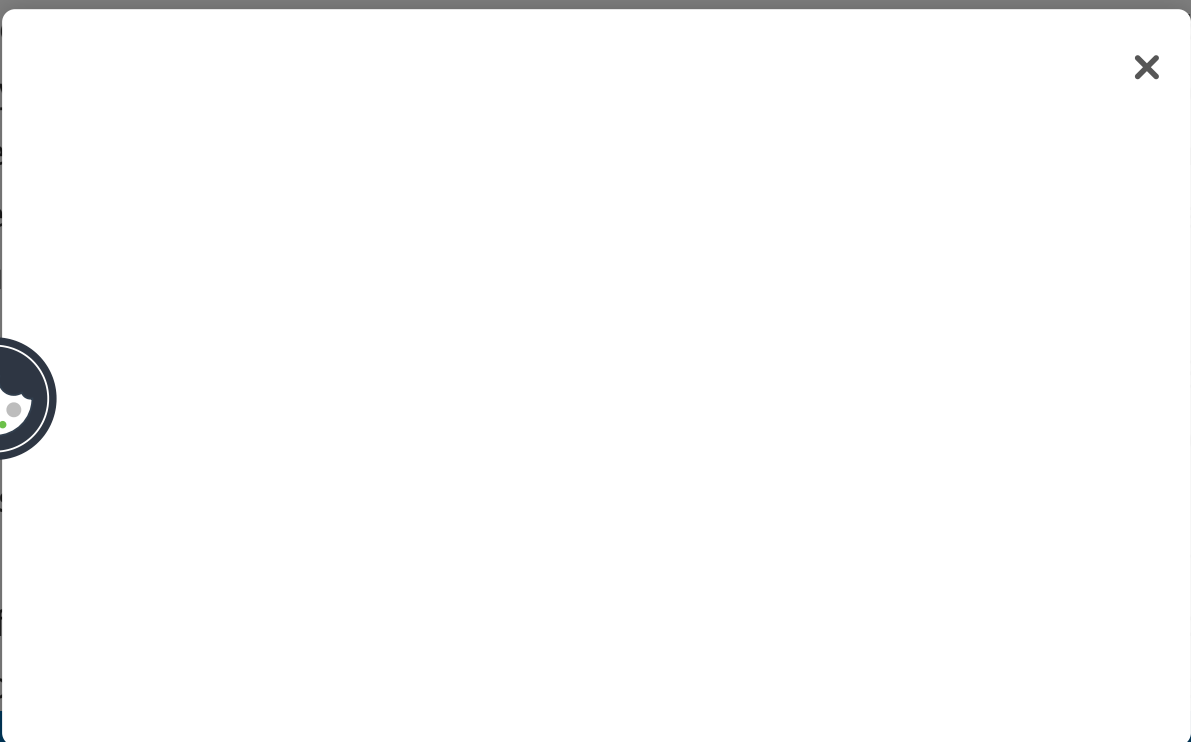
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into the Champions League'. Long-term foreign inflows into Chinese stocks are estimated at US\$400 billion over the next decade (He, [2018](#)). However, China's index inclusion was a quite contested, political process. Many observers suggested that Chinese regulators had to make concessions, with the main issue being guaranteed investor access to China's relatively closed market. As one interviewee noted, 'MSCI have actually accomplished quite a lot by the inclusion. It's amazing that it was an external, private organization that suddenly gets CSRC [China Securities Regulatory Commission] and government officials to bend and to agree to things that they would never would have agreed to in any other circumstances' (Interview 6). As another interviewee highlighted, MSCI has a quasi-regulatory function - 'even though MSCI is not a regulator, companies need to abide, to respect their rules' (Interview 4). Since the inclusion, MSCI for instance delisted several Chinese companies that suspended the trading of their shares as this violated market accessibility (Interview 13). Over the years, MSCI has been in close contact with the Chinese counterparts, advising regulators on how to regulate markets to meet inclusion requirements or informing Chinese companies about MSCI corporate governance standards (Interviews 4, 6, 13). Other observers, however, voiced concerns that the inclusion was a result of pressure from the Chinese government and the promise of rising profits for MSCI through increased access to China (Bird, [2019](#)). In any case, China's inclusion into MSCI indices was not a neutral technical exercise but a highly political process with a significant impact on the global allocation of financial assets that requires further investigation.

Few states have the power to contest index providers, with China and the US as possible exceptions to the rule. Most countries need to comply with their rules due to their interdependence with the global financial system. In a much tighter sense, the US and China are the only two countries that have a stock exchange that is not fully integrated with the global market. They would no longer be able to trade on their own terms, and could be increasing fears of a market shock. In India, Singapore, and other emerging markets, the inclusion of the S&P 500) are a significant step towards integration. market data agreements with the S&P are a key factor in its Market Access to Derivatives (MAD) program, which provides access to derivative market data.

regulator 'reconsider [their move] before it leads to any unnecessary disruptions in trading or a potential change in the market classification of the Indian market in the MSCI Indexes' (MSCI, [2018c](#)). MSCI effectively threatened India with an exclusion, a subsequent loss of status and investment outflows. At the time of writing, SGX and NSE are cooperating to maintain international investor access by routing SGX trades through GIFT City, India's new international financial center (Coutinho, [2019](#)). This case again highlights the inherently political nature of indexing and country classifications, and the power that index providers have over steering capital flows.

Korea, Brazil and Turkey are also on MSCI's 'watchlist' of countries that could be downgraded if they do not ease investor access (MSCI, [2018b](#); Tan & Robertson, [2018](#)), highlighting the needs to comply with the rulebook drafted by index providers. In order to affect classifications, countries 'have homework to do' and 'boxes to tick' (Interview 9) - simply talking with index providers is not sufficient, 'they really need to make effective changes' (Interview 13). The index reclassification of emerging countries is expected to result in a 'seismic shift' of over US\$120 billion in active and passive fund flows in 2019 alone (Robertson & Lam, [2019](#)). Hence, in the age of passive investing the reclassification of countries into 'developed,' 'emerging,' and 'frontier' markets can lead to billions of rapid 'automatic' in- or outflows by funds that track the respective indices. With the move towards passive investing, the locus of agency between international investors and governments has therefore shifted. As this section argued, the actions and judgements of index providers can have important consequences for states.

This paper... their changing politico-... that with the shift to... factors that exerc... ents through the indic... cording to which co... uence investm... s of those compan... e that rather



are trusted by the international investment community and which are entrenched via network externalities. Given the continuous shift towards passive investment, the dominant position of the three big index providers will most likely persist in the coming years and merits further research. In the remainder of this conclusion we thus develop a research agenda from an IPE perspective.

We see three main research avenues: the first is index providers themselves, including their decision-making processes and their embeddedness in the index funds ecosystem. It would be essential to further open up the 'black box' of how the big three index providers make decisions, which includes the interaction with their most

important client group and stakeholder - the investor community. We argue that to a certain extent index providers act as consensus-building agents for the asset management industry. But how exactly do they weigh the interests of different investors, especially those of the big three passive asset managers BlackRock, Vanguard, and State Street? To what extent do they reflect a minimum consensus of the asset management industry or rather go beyond such a consensus and initiate reforms? We have identified the powerful brands of the three large index providers as a major source of their authority. But further research is required how persistent these brands are, and how precisely competition works in this concentrated industry. Can we speak of a global oligopoly or is it rather a series of national/regional and segment quasi-monopolies as in most countries there are usually only one or two indices in which invested assets are concentrated and which, therefore, are most liquid. This also warrants a closer exploration of the financial infrastructures into which index providers are embedded such as market data, analytics and derivative markets and how they



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differences in the sources of their authority, how they exercise it and influence global finance. Another field of study is the (emerging) regulation of indices and index providers. In the case of credit rating agencies, regulation only entrenched their roles as market authorities (Sinclair, 2005). Especially since the LIBOR-scandal, indices have also become subject to regulation through the EU Benchmarking Regulation or the IOSCO Principles for Financial Benchmarks. This poses questions about how these regulations will affect the highly concentrated index industry and about the role of index providers in those regulatory processes.

Footnotes
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The second area of research is the influence of index providers and their index methodologies on the corporate governance of listed corporations. As consensus-building agents for the (mainly Anglo-American) investor community, the big index providers seem likely to adhere to minimum standards as they seek their indices to have high representativity. Nonetheless, we think that their role as de facto standard-setters will receive increasing attention in coming years, by investors, regulators and the public. A necessary first step would be to systematically analyze how the methodologies of the big index providers have changed in recent decades. Such an analysis could potentially uncover a hierarchy between the three big index providers, for instance whether MSCI often acted as a first-mover concerning important changes in index methodology. Furthermore, an analysis of index methodologies should focus on how they influence corporate governance standards, including their potential enabling of tax avoidance by allowing member companies to be legally based in 'domiciles of convenience'. The role of index providers in relation to green finance and climate change is also a topic that needs to be investigated as their brand-recognition and standards

(environmental) management. As arguably also play a role in steering capital to

The index providers' influence on corporate governance is not only significant but also different from an IPE perspective. The IPE perspective is based on the criterion in the methodology of country (re-)classification. The index providers' influence on corporate governance is closely related to the IPE perspective.

Mixed methods research
In this article



Abstract the financial openness of emerging markets and their position in index categories and/or watchlists. Such an approach could also offer important insights into the specific causal mechanisms at play and help to better understand the ‘steering capital’ effect of index authority in equity markets. Complementary research should be conducted on the role of growing bond indices for emerging markets, as they directly influence sovereign debt. Especially in the context of a comparative capitalisms framework it might be worthwhile investigating the impact that index providers have on countries’ financial regulations, because it seems likely that index providers tend to spread standards from liberal market economies, where most of the investor community is based. One particular case that deserves close attention is the inclusion of China in key global equity and bond indices, as this will be the largest instance of steering capital in the foreseeable future. In this age of passive asset management, index providers ‘have become finance’s new kingmakers: arbiters of how investors should allocate their money’, in the words of The Economist (2017). Recognizing their new role as private authorities is crucial to understanding the ongoing transformation of global finance.

List of interviews

1. Managing director of index provider in Hong Kong (6 July 2017).
2. Business development unit of exchange in London (11 October 2017).
3. FX trading desk of bank in Frankfurt (25 January 2018).
4. Internat
5. Busine
6. Gener
7. Busi
8. Forme
9. Head o
10. Senior



[2. Senior managing director at index provider in London \(3 September 2019\).](#)

[3. Research department at index provider in Shanghai \(23 September 2019\).](#)

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economy of asset manager capitalism, including the power of the 'Big

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Three' passive asset managers and the new role of index providers
(j.r.fichtner@uva.nl).

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Notes

1 When several interviews confirmed statements or mentioned specific aspects, they are referenced without direct quotes, e.g. (Interviews 7-9).

2 Others have highlighted different dimensions of private authority, such as the moral authority of private actors (e.g. [Barnett and Mehdizadeh 2015](#)).

private authority

3 We thank

4 Interview

5 ESG

6 Index

often used

7 Important



8. Country classification schemes are relatively similar: MSCI and S&P DJI (Frontier; Emerging; Developed) and FTSE (Frontier; Secondary Emerging; Advanced Emerging; Developed) (FTSE, [2019](#); MSCI, [2018a](#); S&P DJI, [2018](#)).

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9 Also confirmed in Interviews 5, 8-10.

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Source: Oxford University Press (OUP)

Private Authority, Technical Authority, and the Globalization of Accounting Standards

Source: Cambridge University Press (CUP)

Debate: International Financialization in DEEs

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Anticompetitive Effects of Common Ownership

Source: Wiley

Ownership concentration and institutional investors' governance through voice and exit

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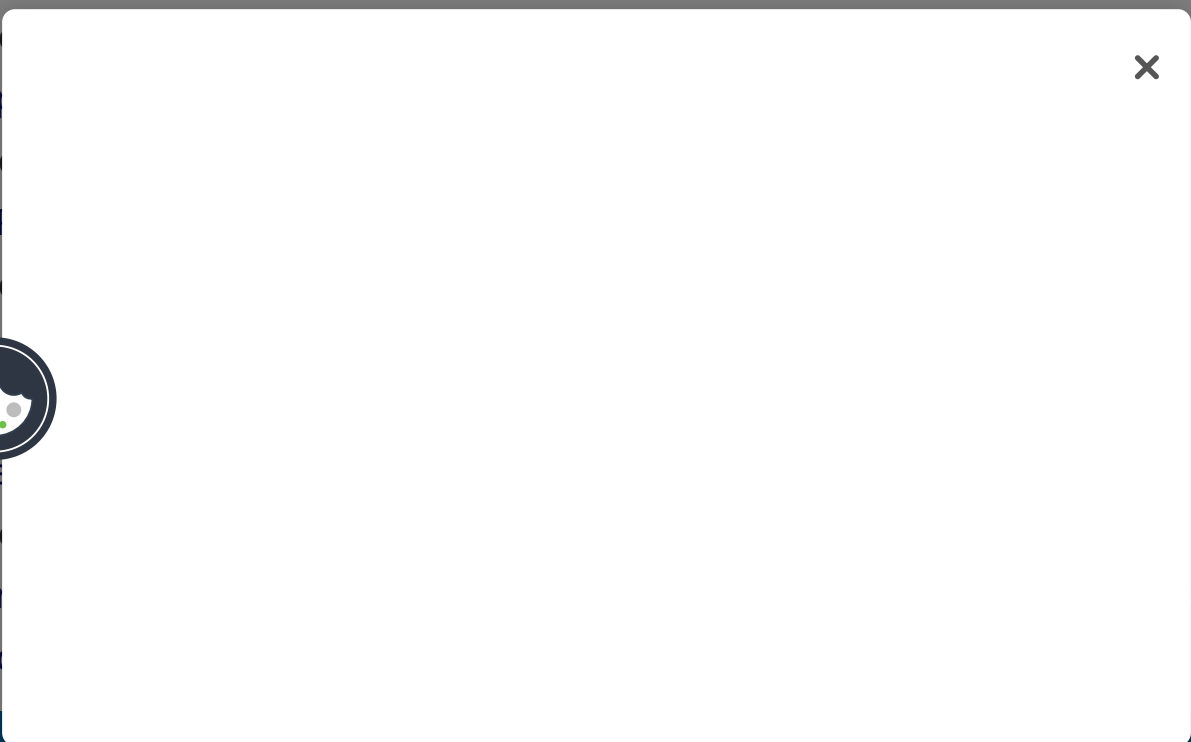
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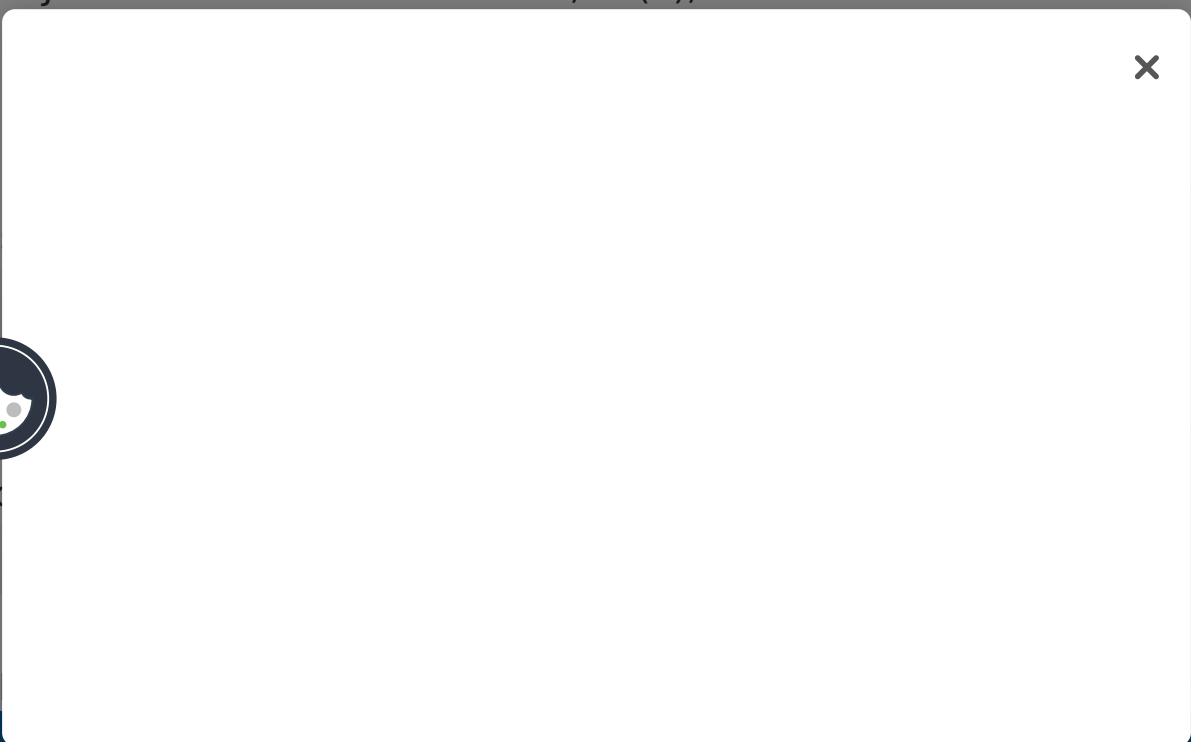
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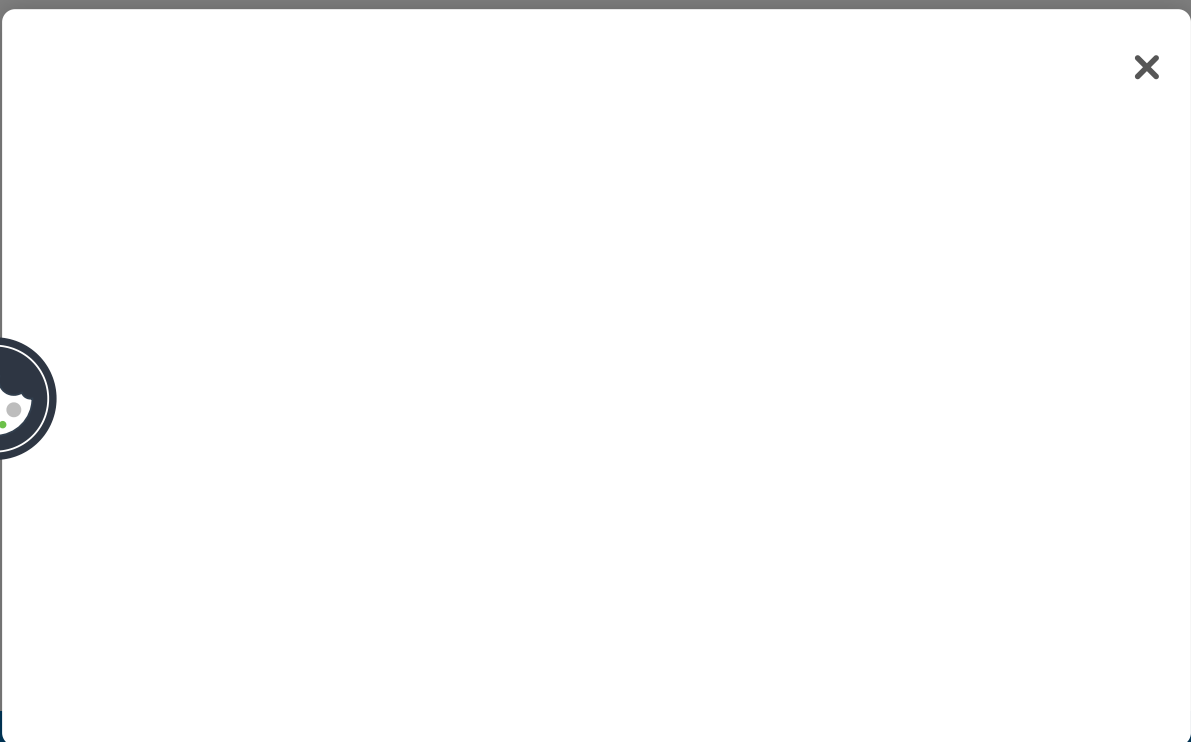
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