

Securities and Exchange Commission  
Via email to [rule-comments@sec.gov](mailto:rule-comments@sec.gov)

***References to Ratings of Nationally Recognized Statistical Rating Organizations;  
Security Ratings; Proposed Rules - File Numbers S7-17-08 / S7-18-08 / S7-19-08***

London, September 5<sup>th</sup>, 2008

Dear Sirs,

Markit welcomes the publication of the Securities and Exchange Commission's proposed rule on *References to Ratings of Nationally Recognized Statistical Rating Organizations* and we appreciate the opportunity to comment on it.

Markit is a financial information services company with over 1,000 employees in The United States, Europe, and Asia. Over 1,000 financial institutions use our independent services to value financial instruments, manage risk, improve operational efficiency and meet regulatory requirements. As we are a developer and provider of independent pricing data and asset valuations to commercial and investment banks, hedge funds, insurance companies and regulators for cash and derivative asset classes, Markit is involved in a number of the issues that you touched upon in your proposed rules. With that experience and expertise as context, we welcome the opportunity to provide you with the following comments.

Regulators and market participants alike are currently considering whether and how to tackle the issue of "undue reliance" on credit ratings in their own rules. Potential rule changes aim to ensure that credit rating information is but one input that informs a minimum standard of investor due diligence. We envision several required clarifications and developments if the rules are implemented as proposed.

Assigning investors with the responsibility for judging whether a product qualifies as "investable" creates a related requirement for the availability of clear guidance on how to define and calibrate alternative measures of the risk properties of such investable assets. Absent this clear guidance, investors would likely incur significant administrative costs, and experience elevated levels of uncertainty. The systemic effect could be very meaningful, with the potential to impair the ability of investors to transact business. We believe that prior to the removal of references to ratings in investment rules, market participants should explore alternative methodologies to evaluate the risk properties of a product. While, most importantly, alternative provisions should be an accurate reflection of the risk parameters that they are aiming to measure, they should also be forward-looking, objective, observable, easy to source and simple to compute. Only this combination of attributes will maximize market transparency while minimizing the cost and potential for uncertainty of the process.

It is generally accepted that the decision as to whether a product qualifies as investable should be based on an informed and thoughtful judgement of the product's level of actual and measured credit risk, liquidity, and volatility. Removing references to credit ratings, that traditionally focus solely on credit risk, will leave investors with the challenging task of deciding whether an instrument contains "minimal" or "no greater than moderate" credit risks, but also with the question whether it is "sufficiently liquid". To minimize the burden on

investors, it is thus advisable to check whether the characteristics of credit risk, liquidity and volatility are quantifiable, whether they can be easily measured and whether there is a ready source for the relevant information.

The financial markets are highly sophisticated, and have evolved to provide independent indications of all three required product characteristics, including credit worthiness, liquidity and volatility. Market based measures are easily observable and transparent, updated frequently, and built on both the expectations and actual transactions of all relevant market participants. The use of a large and complimentary set of relevant data to inform the measures of credit risk, liquidity and volatility of a financial product presents material advantages. While some additional research might be helpful in forming a consensus judgement as to whether and which market-based measures are best suited as proxies for these risk properties, the following is a summary of our thoughts on these topics.

### **Minimal Credit Risk Determination and Monitoring**

Credit markets incorporate all available information processed by all market participants at any point in time, and provide a market clearing price for many names on an almost continuous basis. Traded credit spreads hence may prove to be the most accurate measure not only of the current credit risk of a specific name but also be a good predictor of its future development. Whilst the approach of using actual credit spreads to measure credit risk has been implemented by some market participants and discussed in the academic literature to a certain extent, we feel that further research might be helpful in determining how accurate the predictive quality of credit spreads is, how credit spread information could be used in practice, and also what actual measure of the credit spread should ideally be used to avoid potential undesired side effects such as pro-cyclicality or elevated volatility.

Markit collects tens of thousands of price points on financial products from all active market makers every day, ranging across markets including bonds, CDS, and ABS, to exotic derivatives across the asset classes of interest rates, equities, commodities, FX and structured credit. We perform a range of cleaning algorithms, such as testing for stale data, for flat curves, or for recycling, in order to produce high quality consensus pricing data across all asset classes and formats of exposure. In Credit Default Swaps for example, approximately 3,500 curves are published every day, with spread history for many of them available from 2001. Furthermore we capture current bid/offer levels on many of these names through intraday dealer quotes, and compute intraday credit spread curves as an amalgamation of end of day contributions and quotes feeds.

The determination of "Minimal Credit Risk" could easily be based on this wealth of credit spread data sourced from the markets. However, using simply the current credit spread as measure of credit risk might introduce an undesired level of volatility and runs the risk of occasionally being exposed to technical pressures. It might hence make sense to compute rolling averages of credit spreads in order to create credit risk measures with higher stability. That said, there probably needs to be a discussion about the exact nature of the averages, where it might be advisable to use exponentially weighted averages to assign a higher importance to recent spread movements as they will incorporate relevant new fundamental information for this name. Also, it might be worth discussing whether the weightings of such an average should be static or whether they could change. One option might be to allow regulatory bodies to occasionally review and potentially change the weightings or time periods of the averages being accepted in order to reflect special market situations or avoid any undesired pro-cyclicality of these credit risk measures.

Regarding your proposed amendments to Rule 10b-10 it is worth pointing out that if the information that a security is not rated were to be removed from the confirmation of transactions, the usage of a credit spread as credit risk measure for that name could be a helpful replacement. The usage of credit spreads for this purpose would be much more

accurate, and would be capable of revealing that many unrated securities are actually less risky than rated ones.

Referring to the proposed changes to the Net Capital Rule it is worth pointing out that in this particular area the benefits of using a credit spread based approach have been demonstrated over the last year. Using credit ratings to compute counterparty risk for example in the area of monoline insurers produced very different results as compared to a calculation based on credit spreads. This more market-based approach has almost certainly been used in one form or another by some market participants to compute counterparty risk in their internal systems. A reference to market sourced credit spreads could represent a more transparent, simplified, and standardized way to achieve a similar result, whilst reducing potential conflicts of interest inherent in allowing the usage of internal models. On that basis we support the idea of “market-based models, including models using credit spreads”, where we are of the view that additional guidance should be provided, as discussed above.

The approach of using market sourced credit spreads would also hugely simplify the ongoing task of Monitoring Minimal Credit Risks on a timely basis and at limited cost. Instead of burdening investors with the obligation of ensuring that they are “becoming aware of any information which suggests that the security may not continue to present minimal credit risks”, which not only requires continuous monitoring of the news services but also deciding whether a piece of news is relevant, investors could simply use the power of the markets that perform the task of checking for news and incorporating it into spreads anyway, on a constant basis and at no additional cost.

Besides using market credit spreads to measure the credit risk of an investment, the measurement of volatility of investment products could be based on the same data set, where likewise the major challenge would not really be the data input, but rather the exact way in which the measure of volatility should be calculated.

To summarize, we are of the view that the usage of market-sourced credit spreads as a measure of credit risk would be beneficial to market participants. Such a measure could be used to support existing credit ratings, as input into dealers' own models, or as the basis for a standardized, market wide measure as agreed with regulatory bodies. Needless to say, this approach would have the potential to significantly reduce regulatory compliance costs for the affected market participants as compared to most alternatives.

### **Portfolio Liquidity**

Following the proposed definition of a “liquid security”, the ideal measure for the risk property “liquidity” of a financial product should reflect the ability of an investor to sell the product in the market within a certain time period at a level close to the current price. However, the challenge consists in quantifying and measuring this “potential future liquidity” for financial products in an objective and accurate way. The measure should be observable, dynamically updated, forward looking, and it should be available for the majority of all relevant products.

Unfortunately, liquidity is not only an important risk property of a financial product, but is also notoriously hard to measure. Whilst some market participants would propose using actual trading activity in the past to measure potential liquidity in the future, the usage of transactional volumes is exposed to a number of theoretical as well as practical issues, making them rather ill suited for the desired purpose:

- Daily trading activity can only ever be observed for a very limited part of the universe of all tradable products, and only for a subset of these are trading volumes actually publicly available. Liquidity measures derived from actual trading volumes could hence only be computed for a small number of products, and couldn't really serve as the benchmark measure for liquidity for the population of the entire market.

- Even for products for which trading volumes are available on a more or less regular basis, additional information would be needed to derive real liquidity indicators. In CDS for example some of the relevant questions would be: Is an isolated trade of USD 1bn notional in a 1 year maturity really a sign of liquidity for this name in general? Should the number of trades or the volume be used to measure liquidity?
- The fact that a product hasn't traded in the recent past should not be regarded as proof that it is not liquid, and the investor couldn't sell it quickly if he wanted to. Some products that might not trade today because there just isn't enough interest in them currently are potentially very liquid if you want to trade. Think of a tight spread name in CDS: it might not trade because no one cares to buy protection on such a high quality credit; however it will probably be very easy to receive quotes from a number of market makers and trade in size with a tight bid/offer, close to the current market price, if you only wanted to.
- Finally, as the recent past has shown, the actual turnover of a product can dry up suddenly depending on the market situation, and past turnover has therefore proved not to be a consistent and accurate predictor of availability of liquidity in the future.

Given the described issues it is fair to say that, while it has value as additional input, transactional data alone will not suffice to measure future liquidity for the whole universe of relevant products. Fortunately, there exists a much more reliable and appropriate way to measure the liquidity of financial products: the Data Quality Rating, a parameter that we have been computing and publishing for many years based on the variety of daily market data contributions we receive.

Markit's Data Quality Ratings can be used as a good proxy for liquidity of a product, given that they are derived from the following input parameters:

- The number of accepted pricing contributors for the product, i.e. the ones that are accepted after rejecting many others based on our cleaning algorithms;
- The freshness of the data, i.e. when the contributions were last updated by the contributors, and
- The range of accepted contributions, i.e. the difference between the highest and the lowest accepted prices.

All else being equal, a higher number of accepted contributors, a greater freshness of the data, and a narrower range of accepted contributions will lead to a higher Data Quality Rating. Importantly, it will also signal a higher liquidity for this product, as more market makers trade the name and will provide prices when needed, they frequently update their prices which reflects the ability of an investor to receive a number of tradable prices quickly, and there is little disagreement about the current price, which implies a tight bid/offer spread for decent size should be expected. If all of these factors are in place, they signal that the investor will likely be able to liquidate a position quickly, and close to the current price when needed. Data Quality Ratings are dynamic and will reflect changes in the underlying variables on a daily basis. Please note that a paper describing the details of the computation of Markit's Data Quality Ratings is available on request.

In addition to these three inputs, we are currently in the process of integrating quotes data, i.e. live bid/offer runs that we receive from the market makers, as well as transactional data, where we have it, into this liquidity measurement concept. One way of doing so will be to give a higher liquidity rating to names that appear on a number of quotes runs every day, as it signals that this name is actively traded by multiple dealers. We are also working on ways to

take the quoted bid/offer into account, with a tighter bid/offer justifying a higher Data Quality Rating and liquidity.

Based on the current data set we do publish Data Quality Ratings for more than 2,100 Credit Default Swaps (5 year maturity point) and more than 5,300 bonds globally. In CDS more than 210 names achieve a AAA rating for their liquidity, with 780 being in the AA, and 382 being in the BBB category respectively. In the universe of bonds, reflecting a smaller number of contributors, less frequent updates, and a wider range of contributions, the majority of the bonds will fall into the BBB and BB categories, an indication of the generally lower liquidity of bonds compared to CDS.

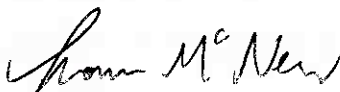
Referring to Rule 15c3-1, it should be said that the combination of a market based credit risk, volatility, and liquidity measure is expected to provide an accurate, dynamic, and transparent reflection of these risk characteristics. Instead of solely relying on an investment grade rating, implicitly assuming that such a rating would be highly correlated with the liquidity and volatility of the product, a separate measurement of these characteristics will result in a more accurate overall risk analysis. Using the described approach for this rule would clearly satisfy the stated objective, that "net capital computations" should be a reflection of the market risks inherent in those securities.

In response to the proposed rules on Security Ratings in File No. S7-18-8, we would like to point out that Data Quality Ratings could also be applied to measure the "market following for debt issuers". The fact that a name is quoted by many market makers, prices are often refreshed, and there is little disagreement about the current price, could provide a more accurate, and also dynamic proxy for that characteristic of a name, compared to using the notional amount of bonds that have been issued in the past.

Markit is open to engaging in a constructive dialogue with regulatory bodies and academics interested in how credit spread data could be used to conduct a study on the predictive qualities of credit spreads compared to credit ratings, and on how a credit risk measure based on credit spreads should ideally be defined and calibrated. We are equally interested in discussing with regulatory bodies how to best measure liquidity of a product based on a range of market sourced inputs and how to potentially further develop and refine the definition of Data Quality Ratings to make them most useful for your purposes.

We hope that these comments will be of value for you. Please don't hesitate to contact us if you require additional information or if you want to discuss.

Kind regards,



Tom McNerney  
Managing Director  
Data and Analytics



Marcus Schüler  
Managing Director  
Regulatory Affairs