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European Commission
Directorate General Internal Market and Services
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Via email to markt-g2-consultations@ec.europa.eu

Consultation Document: Possible initiatives to enhance the resilience of OTC Derivatives Markets

London, August 31st, 2009

Dear Sirs,

Markit welcomes the publication of the *Consultation Document: Possible initiatives to enhance the resilience of OTC Derivatives Markets* and we appreciate the opportunity to provide you with our comments.

Markit is a financial information services company with over 1,200 employees in Europe, North America and Asia Pacific. More than 1,500 institutions use our independent services to value financial instruments, manage risk, improve operational efficiency and meet regulatory requirements.

Over the last few years Markit has been working actively with the industry to increase the resilience of the OTC derivatives markets, e.g. by performing services such as the credit event auctions for credit default swaps (CDS) or trade compression for OTC derivatives. We also own and operate Markit Wire, the leading trade processing platform for OTC derivatives which performs electronic confirmations and has been feeding trades for central counterparty (CCP) clearing for many years. Markit Wire will be combined with DTCC's Deriv/SERV operations on September 1st to create MarkitSERV, an integrated, global trade processing platform for OTC derivatives across all asset classes.

We are also a leading provider of independent pricing and valuation services for OTC derivatives, operate the Reference Entity Database (RED) for CDS, and administer the tradable credit indices Markit iTraxx and Markit CDX. Given the range of OTC derivatives related services that we provide, we are working closely with all potential providers of clearing services in Europe, North America, and Asia, enabling them to access reliable pricing data, licences, and other relevant services.

That said we feel well positioned to comment on your consultation on how to increase the resilience of OTC derivatives markets and we hope you will find our comments useful.

Standardisation

1. What would be a valid reason not to use electronic means as a tool for contracts standardisation?

The OTC derivatives market creates value by offering market participants the flexibility to customise products to match their specific risk management needs. Efforts to increase the resilience of the OTC derivatives markets should therefore refrain from reducing this valuable choice by forcing standardisation upon OTC products themselves. Regulators should instead aim at standardisation of legal terms and processing procedures as this will provide the pre-condition for reducing operational and systemic risks as well as for increasing transparency. At the same time it will preserve the value that the OTC derivatives market creates.

In our view, capturing the complete information of an OTC derivative trade in an electronic format early during its life cycle (Execution – confirmation – clearing – data repository – life cycle events) should be regarded as a pre-requisite to increasing the resilience and the transparency of the market. Whilst the degree of standardisation of legal terms is relevant for the eligibility of a product for electronic processing during all stages of its life cycle its eligibility for electronic execution and clearing will in addition depend on its actual liquidity and reliability of pricing. That said one can assume that there will only ever be a portion of all OTC derivative products that can be electronically executed or cleared, i.e. the ones that are both standardised and liquid. In contrast it should be expected that all products that have sufficiently standardised legal terms can be captured through electronic trade processing and in central data repositories. It is worth pointing out that even for OTC derivative trades that are highly customised some kind of electronic trade record can be created. These so called “copper” records will capture some key terms of the trade in a central trade repository without aiming to register all of its details.

All said we are a strong supporter of the regulators’ calls for wider adoption of faster and automated affirmation and confirmation of all OTC derivatives trades. We are of the view that this stage of the life cycle will play a crucial role in further reducing risk and increasing transparency for the OTC derivatives market across all asset classes and products.

2. Should contracts standardisation be measured by the level of process automation? What other indicators can be used?

As described above we are of the view that process automation and electronic trade capture, which can occur at different stages of the life cycle of the trade, are the necessary pre-conditions to increasing both the resilience and the transparency of the OTC derivatives markets.

While the degree of legal standardisation of a product determines whether the product details can be transformed into electronic information additional factors will have an impact at some stages of the life cycle. For example, when deciding whether a product is eligible for clearing it matters whether it is sufficiently liquid, a reliable price can be determined on a daily basis and the product can be effectively risk managed. For Credit Default Swaps while their documentation is nowadays fully standardised across all entities, only those names that are sufficiently liquid should be expected to be eligible for central clearing. That said we have reservations as to whether regulators should attempt to measure the level of product standardisation.

We are a strong supporter of the regulators' calls for wider adoption of faster and automated affirmation and confirmation of all OTC derivatives trades, as well as of portfolio reconciliation and compression to increase the resilience of the OTC market. Markit has been actively involved in these areas by offering a number of services:

- Markit through its Markit Wire platform currently enables the electronic confirmation of over half of all OTC interest rate derivative trades globally, with over 95% of these trades being confirmed on trade date. Also, for many years Markit Wire has been the major provider of interest rate derivative trades into LCH.Clearnet's SwapClear platform, which is the leading CCP for the interbank interest rate OTC market.
- On September 1st we will combine our Markit Wire trade processing platforms with DTCC's Deriv/SERV post-trade confirmation and matching services to create MarkitSERV, a company that will be headquartered in London and will be owned equally by Markit and DTCC. MarkitSERV will provide a single gateway for processing OTC derivative transactions across asset classes globally, separate from DTCC's Credit Trade Information Warehouse. The platform will provide services for more than 1,500 global dealers, asset managers, inter-dealer brokers and other market participants, and will process millions of OTC derivative transactions each year. All said we expect MarkitSERV to be instrumental in the efforts to reduce operational risk, streamline processing and improve the safety and certainty of the OTC derivatives markets.

4. What other incentives toward standardisation could be used, especially for non-credit institutions?

One impediment to standardisation and electronic confirmation is the divergence of views of different regulators, and differences between jurisdictions in relation to the legal status that is achieved by confirming electronically. We would therefore urge regulators to coordinate globally, reach an agreement on the importance of electronic processing and ensure that it is accepted in their respective jurisdictions.

Strengthening bilateral collateral management

7. How frequently should multilateral netting be used?

Over the last couple of years the derivatives industry has launched significant initiatives to reduce the number of economically redundant trades with trade compression now being performed for different asset classes on a regular basis. Markit is responsible for the market standard portfolio compression service for single-name CDS together with Creditex, a service which since its launch last year has reduced the economically redundant positions in the portfolios submitted by over 37%, equivalent to over \$4.6 trillion notional and more than 625,000 trades.

Looking ahead, it is worth noting that even for markets where CCPs successfully operate, there still seems to be a need for a compression service. This will certainly be the case for CDS referencing illiquid credits, but also applies to the interest rate derivatives market where there is still significant demand for compression services despite the fact that CCPs have been used for many years.

Based on our experience it will be difficult to appropriately define a required frequency for compression. While from a regulatory perspective it might be desirable to perform compression cycles as often as possible the ideal frequency will ultimately be a function of the actual potential for netting and the availability of front and back office resources. Whilst we typically perform one compression cycle for CDS each week in Europe and North America respectively, the occurrence of major defaults for example can cause delays to the scheduled compression cycles.

Central data repository

9. Are there market segments for which a central data repository is not necessary or desirable?

We are of the view that central data repositories in principle might have relevance for all OTC derivatives across asset classes and products. DTCC's Trade Information Warehouse provides a precedent as it offers a central venue to store the trade confirmation results for standardised CDS. This allows market participants and supervisors alike to assess the current status of a contract and use it as basis for further post-trade processing actions.

That said, we believe that a number of issues should be considered in this context:

- It will require time and effort to create central data repositories for other asset classes as well as for customised products. Also, for customised products one has to recognise that even once a data repository has been built and all trades have been uploaded, these "copper records", while certainly helpful in ensuring that even non-standardised trades are captured, can not reflect the complexity of the underlying exposures in a meaningful way.
- Given the global nature of the OTC derivatives markets regulators should coordinate and ensure that the creation of just one central data repository globally for the relevant asset classes will suffice, as long as the respective repositories are committed to providing access to all global regulatory bodies on equal terms. Any deviation from that principle will only increase costs through duplication and open the door to regulatory arbitrage.
- The requirement to build central trade repositories should not stand in the way of the benefits of liquidity and innovation that the OTC derivatives markets provide to users around the globe on an ongoing basis.
- Trade repositories should not necessarily be required to also handle life cycle events. Whilst the DTCC Credit Trade Information Warehouse performs this function which has particular relevance for CDS, the creation of "simple" trade repositories should be sufficient to assist in increasing transparency for asset classes such as interest rates or foreign exchange.

10. Which regulatory requirements should central data repositories be subject to?

As mentioned above regulators should agree on standards of their access to data repositories to avoid duplication of reporting and potential overlap of responsibilities.

11. What information should be disclosed to the public?

Whilst regulators should have access to the details of all OTC derivative trades that are captured in the data repositories, the information that is revealed to the public should be limited to aggregate data. Only by aggregating trade and position information across the market or counterparty groups without disclosing the exposures of specific parties can one ensure the confidentiality of the individual transactions.

The granularity of the information that is published by the DTCC Trade Information Warehouse for standardised CDS provides a valuable precedent. We are of the view that reporting of aggregate turnover and open interest, with a breakdown by relevant product categories, counterparty groups and maturities on a weekly basis is appropriate to allow the public to gauge the extent of activity and exposures in the OTC derivatives markets.

CCP clearing

12. Do you agree that the eligibility of contracts should be left to CCPs? Which governance arrangements might be necessary for this decision to be left to the CCPs' risk committees?

In our view there are a number of reasons why it is neither possible nor desirable to create legislation prescribing which OTC derivative products should be eligible for clearing by CCPs:

- The recent discussions around central clearing for CDS have demonstrated that central clearing of OTC derivatives is a fairly new concept for some asset classes, and best practices for procedures and risk management will therefore evolve over time.
- The eligibility of OTC products for clearing will not only depend on their standardisation but also to a significant extent on their liquidity and the ability to effectively risk manage positions. As we know liquidity conditions can change, and with them the scope of clearable products. Also while clearing has started for the credit indexes and will soon be offered for single name CDS, it seems too early to tell what portion of the single name CDS market can actually be cleared. That said we are of the view that parties that are directly involved in the market are in the best position to judge whether a product is sufficiently liquid and should be considered for central clearing.
- The derivatives markets are dynamic and new products will emerge on a regular basis. It is difficult to imagine that legislation that contains criteria for clearing eligibility can ever be flexible enough to accommodate the whole variety of potential new product variations.

All said we are in favour of leaving the decision about clearing eligibility of a product to the CCPs themselves, based on their risk management capabilities, the individual product characteristics, market conditions and the ability of the major market participants to support the default process. However given that CCPs mutualise risk between their members it is important that members have a strong influence on these decisions and extensive risk management testing is performed in conjunction with members when deciding about the suitability of a product for clearing.

Ultimately regulators should realise that CCPs in conjunction with their members are in the best position to judge whether a product should be eligible for clearing. This should be acceptable from a policy perspective as long as non-clearable products are subject to operational best practices, electronic trade processing and life cycle management, and enhanced transparency requirements similar to the ones that apply to cleared products.

13. What additional benefits should the CCP provide to secure a broader use of its services?

While CCPs are often regarded as the natural choice to perform transaction or position reporting to regulators and the public we are of the view that reliance on this source can only create a rather unsatisfactory level of transparency:

- Only a portion of all OTC derivatives products will ever be cleared,
- The overall volumes of cleared trades will often be split between competing CCPs, and
- Often CCPs do not capture the trade information in a sufficiently timely fashion with clearing cycles for CDS for example currently being only conducted on a weekly basis.

While CCPs will be required to perform regulatory and public reporting, regulators should aim to implement a reporting regime that can provide the full picture by consolidating trade information from different CCPs and aggregate it with non-cleared trades, ideally in a timely fashion.

18. What is the minimum acceptable ratio of CCP cleared/eligible contract? What is the maximum acceptable number of non-eligible contracts?

We are of the view that as general principle regulators should focus on creating the right incentives instead of mandating rigid rules. That said we regard it as almost impossible to come up with minimum acceptable cleared/eligible ratios for the different markets, products, or market participants. We think that as long as incentives exist to clear and best practices are consistently applied to the handling of non-cleared trades regulators should be satisfied with allowing market participants to decide for themselves what is optimal given the circumstances.

19. What statistics need to be provided to regulators to make sure they have all the information necessary to perform their duties?

To monitor the risks that are taken via the OTC derivatives markets regulators should be provided with aggregate exposure across entities and counterparties, while they should also be able to access the individual position information for each counterparty. That said, one must wonder why in the context of transparency to regulators the focus is mostly on introducing additional reporting requirements for the industry, as opposed to how the data is actually received and used by the regulators. The following points should therefore be considered before introducing additional reporting requirements to ensure that they not just create an undue burden for the industry:

- Are regulators in a position to properly handle and understand the huge amount of data that they might receive for OTC derivatives, products that many of them have never really dealt with before?
- Are regulators able to cross reference and aggregate transactions across asset classes as well as products? Can they properly identify OTC transactions to facilitate the exchange of reported information between themselves?
- Are regulators in a position to not only monitor notional positions but, much more importantly from a supervisory perspective, also of deriving the actual mark to market exposures?

Any reporting requirements that are mandated before ensuring that regulators are capable of performing the above tasks is likely to impose a burden on the industry without delivering any benefits from a regulatory or systemic risk perspective.

20. How could European legislation help ensuring safety, soundness and a level playing field between CCPs?

We generally support the recently published ESCB/CESR recommendations for CCPs. However, we regard it as important that legislation is created to ensure open access for a variety of market participants to the different CCPs independent of the trade execution venue. It will only be by providing this kind of open access to CCPs that the efficiency gains and risk reduction that they offer can be maximised.

In addition, we are of the view that legislators need to carefully design minimum standards related to the risk management of CCPs, margin requirements and investment risks in particular. Such legislation can help preventing a potential “race to the bottom” where competing CCPs could lower their margin requirements in order to attract business. We are of the view that in this context the measurement of liquidity risk warrants particular attention.

Liquidity Risk

CCPs for OTC derivatives have to perform the challenging task of performing risk measurement with systemic importance for thousands of products on an ongoing, and even on an intraday basis. The goal must therefore be to identify reliable measures of credit, volatility, and liquidity risk of their positions in OTC derivatives and for the products that they accept as collateral. Regulators should ensure that CCPs will only accept assets as collateral that have minimal credit, market, and liquidity risks. Also CCPs should take historic

price volatility, jump to default risk and market liquidity into account for their margin calculations, all of which can change throughout the life of the transaction. The real challenge in this context lies in determining how these risk properties will be measured in practice. It is quite surprising that sometimes rather static measures are accepted that fail to reflect the dynamic nature of the risk that a CCP is exposed to and seem neither sufficiently objective nor scalable.

Ideally the risk measures that are used by CCPs will not only be an accurate reflection of the current level of the relevant risk parameters but they should also be updated dynamically, available for the majority of relevant products and maturities, objective and observable. Only this combination of attributes will maximise the transparency that a CCP can provide about its risk management methodology and minimise the cost and potential for uncertainty. Fortunately the financial markets do provide independent market-based measures that are updated frequently, and built on both the expectations and actual transactions of all relevant market participants. All said we are in favour of using market-based variables to measure and manage liquidity risk in the context of central clearing, in addition to using credit spreads for credit risk and volatility calculations, as they will provide CCPs with an accurate, dynamic, scalable and transparent measure of one of the major risk characteristics of the products that they clear or accept as collateral.

Finally, we support the view that CCPs should be held to identify and analyse sources of risk from external factors such as trading and settlement arrangements and their vulnerability arising from their reliance on a small number of outside service providers. All external providers to CCPs need to recognise the systemic risk implications of a potential failure in their service and therefore need to put appropriate resiliency and disaster recovery facilities and procedures in place. Markit in its function as a service provider to the CCPs has established detailed service level agreements (SLAs) with respect to the provision of pricing data which requires stringent business continuity plans (BCPs).

Transparency requirements

21. Should MiFID-type pre- and post-trade transparency rules be extended to non-equities products? Are there other means to ensure transparency?

Markit actively contributes to the pricing transparency in the OTC markets by offering quote based services that aggregate bid/offers from dealer runs, as well as end-of-day consensus prices. Based on our experience as a pricing provider we are of the view that the level of pre- and post-trade transparency available to participants in the OTC derivatives markets is quite high already and will only be further increased by the introduction of clearing for many asset classes. That said, while the introduction of a mandatory transparency regime might be justified by the occurrence of serious market failures, for example related to price discovery and valuation, we do not think that this generally applies to the OTC derivatives markets.

Clearing Prices

Markit has been working with CCPs and major participants in the CDS market to devise the most appropriate process to create reliable clearing prices and decide on the appropriate distribution of these prices:

- Markit's input was instrumental in defining and implementing a new price submission process in cooperation with the leading market makers to support the central clearing of CDS. The process is based on the obligation for market makers to provide prices for a defined size with a maximum bid-ask spread within a five minute submission window, with periodic trading activity occurring for off-market submissions to ensure quality of price submissions. Whilst the price that is determined through this process is currently used by some CCPs for CDS margin calculations, we are in discussions on how it could be made available to all others.
- To address the public interest in CDS prices Markit has recently launched a free pricing report that is available at www.markit.com/cds. In total we provide free CDS spreads for roughly 450 entities, i.e. the Markit CDS indices and their constituents, the largest financials as well as G20 sovereigns. For those single names that are centrally cleared we will publish the clearing price for the most liquid 5 year maturity. The remaining clearing prices are made available on commercially reasonable terms.

Post-trade Transparency

Even if the debate about the impact of TRACE and the damage that too much transparency might create has not yielded any clear results, it seems as if many regulators have come to the conclusion that the current level of post-trade transparency in OTC derivatives markets is not acceptable. At the same time most market participants would agree that an ill-designed transparency regime can severely harm liquidity particularly for less liquid products. That said we are of the view that any potential post-trade reporting regime should take into account the characteristics of the specific markets and products to appropriately define the scope, delays and caps for reporting.

Also, when thinking about extending the MiFID post-trade transparency regime to non-equity products, regulators should consider the degree of data fragmentation that was encountered

in European equity markets in the wake of MiFID. As this experience has shown it might take time to resolve the data fragmentation that is created by the use of different trading and reporting venues. Regulators should therefore carefully consider from the start how the aggregation of data could be performed to create readily usable, consolidated transparency for the market. We are of the view that the envisaged reliance on trading venues, CCPs and trade repositories respectively for trade reporting of OTC derivatives would fail to produce the required level of post-trade transparency, as it will suffer from both the fragmentation of data and the lack of timeliness.

All said we are of the view that while today's level of pricing transparency seems already quite high for most OTC derivatives one should expect the introduction of clearing to increase it further. We would therefore question the need for mandating a pre- or post-trade transparency regime and believe that a proper cost/benefit analysis is required before making any decision given that any ill-designed transparency regime runs the risk of producing unintended consequences.

22. How should transaction reporting of OTC derivatives to competent authorities be envisaged? Should it be extended to all contracts or to certain categories? If so, which ones? Are there other means to ensure that the competent authorities receive the relevant information on OTC derivatives transactions?

There appears to be agreement that regulatory authorities should be provided with full transparency about both the activity and the exposures in the OTC derivative markets. When debating whether this reporting should be limited to certain contracts or asset classes one should keep in mind that regulators will use the reported information for a variety of purposes. While transaction information related to credit and equity OTC derivatives seems most relevant in the context of insider trading, trades in all asset classes can potentially have relevance for market manipulation investigations. For the purposes of prudential supervision regulators would probably want to receive a complete overview of all exposures of the institutions they look after regardless of the asset class or the degree of product customisation.

Also in the context of regulatory transaction reporting one should keep the issue of data fragmentation in mind. It seems far from ideal for regulators to rely on separate reporting from the various trading platforms, CCPs and trade repositories as none of them will be able to represent an overall aggregate picture of the market.

Most importantly, any proposed transaction reporting regime should be designed as such that it does not just create a regulatory burden for the industry but produces some real tangible benefits for the regulators and the public. We would therefore urge regulators to work with all stakeholders to ensure that the relevant information is reported in a usable format and duplicative reporting requirements are avoided. Only then can regulators make real use of the data and are in a position to be effective in their supervisory activities.

23. How should position reporting of derivatives to competent authorities be envisaged? Should it be extended to all contracts or to certain categories? If so, which ones? Are there other means to ensure that the competent authorities receive the relevant information on the exposures to particular contracts?

We are of the opinion that the introduction of any additional position reporting requirements, particularly for instruments such as OTC derivatives that many regulators are not very familiar with yet, runs the risk of creating a burden for the industry without delivering any tangible value to the regulators or the public. We would therefore urge you to consider the following factors:

- We expect the issue of cross asset referencing to represent a major challenge in the context of regulatory reporting. Regulators need to ensure that they are not just bombarded by reporting of individual positions, but that they are capable of properly aggregating exposures across both asset classes and products to derive net exposures. As an example, the reporting of positions in corporate bonds, equities, CDS, and equity derivatives will only be truly valuable from a regulatory perspective if bond and CDS positions can be aggregated to derive the net default exposure while only the correct mapping between credit and equity instruments allows for the investigation of activity in products referencing a specific company.
- When discussing position reporting regulators should keep the extent of data fragmentation in mind that was observed in the wake of the introduction of MiFID. They should ensure that any position reporting that is mandated for OTC derivatives can be provided to them in a consolidated and timely fashion.
- We are of the opinion that for the purpose of prudential supervision the reporting of positions in OTC derivatives by market participants will only create real value if regulators are also capable of deriving a reliable mark-to-market valuation for these positions.

All said we would urge regulators to consider and address the challenges related to their usage of position reports before mandating any additional reporting requirements to ensure that they do not just create a burden for the industry but secure the effectiveness of their regulatory activities.

Public trading venues

24. How can further trade flow be channelled through transparent and efficient trading venues? What would be the appropriate level of transparency (price, transaction, position) for the different derivatives markets?

For some market participants the wider adoption of electronic trading seems the logical answer to addressing the remaining trade processing and settlement issues. However, given the bespoke nature of most OTC products and the sheer number of their variations it is rather unlikely that all of them can be traded successfully on exchange or on electronic trading platforms. Therefore, while regulators might want to consider introducing incentives that encourage electronic trading for OTC derivatives only time will tell whether a product can successfully be traded electronically.

Markit is of the opinion that systems and mechanisms must be in place to allow regulators to effectively oversee the OTC derivatives markets. Therefore it is crucial that as many trades as possible are confirmed electronically and a complete record of all trades is created and made accessible in central locations, a procedure which is completely independent of the execution venue. We think it should be acceptable from a policy perspective to permit a choice of execution models as long as efficient electronic affirmation and confirmation mechanisms are in place to achieve the required level of transparency, efficiency and regulatory reporting. Over time activity should be expected to gravitate towards the most efficient trading venue which might be on-exchange for some instruments, and over-the-counter for others.

We hope that our comments are of value to you. Please do not hesitate to contact us if you require further information or if you want to discuss any of our comments in more detail.

Kind regards,



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