

April 11, 2011

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants – RIN 3038-AC96

Dear Mr. Stawick:

Markit¹ is pleased to submit the following comments to the Commodity Futures Trading Commission (“**CFTC**” or the “**Commission**”) on the proposed rulemaking to implement certain requirements included in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “**DFA**”)² titled Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants (the “**Proposed Rule**”).³

Introduction.

Markit views its role in the global derivatives markets as a service provider, offering independent data, valuations and related services for swaps and security-based swaps across many regions and asset classes in order to reduce risk and improve operational efficiency in these markets. As such, Markit supports the objectives of the DFA, and the Commission’s objectives of increasing transparency and efficiency in the OTC derivatives markets and of reducing both systemic and counterparty risk.

Executive Summary.

Markit believes that: (i) agreeing on a “complete” methodology for valuing a swap would often require an almost unworkable amount of detail and may be impossible in some circumstances, thus the Commission should require such agreements to be detailed only to the extent that it is practicable; (ii) the Commission should not implicitly prevent and instead should explicitly permit parties, such as swap dealers (“**SDs**”), major swap participants (“**MSPs**”) and end-users, to delegate determinations regarding inputs, fallbacks, and valuation methods to independent third parties because of the benefits these parties could provide to counterparties and the flexibility this approach creates in dealing with unforeseeable future events; (iii) the Commission should clarify that the proposed requirement that valuation methodologies be “independently verifiable” is merely meant to guide parties in designing their agreements; (iv) recent transaction prices are not always the best indicator of current swap values and the Commission should not assign primacy to any input into the valuation of swaps; and (v) SDs and MSPs should have the choice to use qualified independent third parties for valuation services even for cleared swaps, and the Commission also should not implicitly prevent and should explicitly permit the counterparties to exercise their choice should they wish to delegate this obligation to a qualified independent third party.

¹ Markit is a financial information services company with over 2,000 employees in North America, Europe and Asia Pacific. The company provides independent data and valuations for financial products across all asset classes in order to reduce risk and improve operational efficiency. Please see www.markit.com for additional information.

² Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

³ Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 6715 (proposed Feb. 8, 2011).

1. Require Only Practicable Level of Detail for Valuation Methodologies, Inputs, and Fallbacks.

The Proposed Rule would require parties to any swap to agree upon a “*complete* and independently verifiable methodology for valuing each swap”⁴ which must be “stated with the specificity necessary to allow . . . the value of the swap [to be determined] independently in a substantially comparable manner.”⁵ We believe that requiring parties to agree on valuation methodologies prior to or contemporaneously with execution could be useful to reduce the potential for disagreement about the valuation of swaps in the future. However, given the complexities involved in valuing swaps, we are concerned that the provisions as proposed could be read to require the agreement on a nearly impossible degree of detail. We therefore caution the Commission against requiring from counterparties for these agreements to be too detailed and provide the following input so that the final rule can be useful and practical.

As a provider of valuations for various financial instruments including swaps and security-based swaps across asset classes and regions,⁶ we understand that valuing these products entails a number of complexities. As a result, if the Proposed Rule requires agreed valuation methodologies at the time of execution to account even for minute details, we believe that achieving compliance with the Proposed Rule could become very expensive and time consuming, and sometimes even impossible to achieve.

For example, documentation designed to accurately assess the value of swaps on any given day until maturity of the swap would have to specify, among other things, the exact nature of the pricing model used, the method used to calibrate the model to market data, the parameters used for simulating future states of the relevant pricing variables, the exact methods of interpolation and extrapolation, and the approach for choosing comparable market data when market data required by the pricing model is not observable.

Further, the Commission needs to consider that, even if parties that arrive at a broadly similar view on the current value of a swap, they will find it much harder to agree on the actual methods and inputs of how to produce such current valuation as might be required by the proposed rule.

We therefore believe the Commission should clarify in its final rule that it does not require counterparties to agree on all of the minute details of methods, inputs, and fallbacks that will be used for valuing a swap, but can achieve the desired objective by relying on a more general set of inputs, models, and fallback for valuation purposes. Otherwise, the requirement could lead to extremely technical, expensive, and verbose documentation which would most likely still be insufficient to address all circumstances affecting a swap’s valuation. In addition, the Commission could address these issues by explicitly allowing counterparties to reference values or methodologies as provided by third parties, as further explained below.

2. Counterparties Should be Allowed to Delegate Determinations Regarding Valuation Inputs, Methods, and Fallbacks to Independent Third Party Providers.

The Proposed Rule constructively states that valuations should be based “[t]o the maximum extent practicable . . . on objective criteria, such as . . . valuations provided by independent third parties. . . .”⁷ We believe that this recommendation should be expanded to an explicit authorization for counterparties to agree that independent third party providers (“*ITPPs*”) could provide any or all of the elements that they are required to agree upon for the valuation of swaps.

⁴ Proposed Rule, 76 Fed. Reg. at 6719 (emphasis added).

⁵ *Id.* at 6726 (to be codified at 17 C.F.R. § 23.504(b)(4)(i)).

⁶ Markit Portfolio Valuations provides valuation services for swaps and other financial products to investment managers, fund administrators and custody banks that represent thousands of end-users. During an average month, Markit Portfolio Valuations produces approximately 1,800,000 valuations across many products and asset classes.

⁷ Proposed Rule, 76 Fed. Reg. at 6726 (to be codified at 17 C.F.R. § 23.504(b)(4)).

Today, many participants in the swaps markets are already familiar with and defer to the valuation methodologies, choices of inputs, and fallback valuation procedures as provided by ITPPs, instead of negotiating all such components individually. We also believe that the utilization of ITPPs for the provision of inputs, methodologies, fallbacks, or actual valuations would provide the additional benefit of effectively minimizing potential hurdles created by: (i) the use of SDs' and MSPs' proprietary information or methodologies for swaps valuations; (ii) the financial interest of the parties involved (*i.e.*, SDs, MSPs as well as the end-users); and (iii) unpredictable changes in the markets during the life of a swap.

(i) Proprietary Inputs

The Commission requested comment on whether proprietary inputs should be expressly excluded from permissible valuation methodologies and, if proprietary inputs were permitted, whether SDs and MSPs should be required to disclose such information to their counterparties (*i.e.*, other SDs and MSPs and the end-users) and regulators.⁸ As an initial matter, we do not believe that SDs or MSPs should be required to disclose proprietary information because this could compromise their ability to compete in the marketplace. This impression is in keeping with the Commission's proposed rule regarding business conduct standards.⁹

However, SDs and MSPs will inevitably base their valuation models on some proprietary information. We believe that this problem could be in part addressed by permitting market participants to agree to base a swap's valuation on the methods, procedures, rules, and inputs as provided by an ITPP. ITPPs can generally provide their clients with details of their pricing models and the nature of the data inputs such as curves, volatilities, correlations, or dividends,¹⁰ alleviating SDs or MSPs from any requirement to disclose their proprietary information.

(ii) Financial Interest in Valuations

ITPPs, also, are not trading entities, have no direct financial interest in the prices that they distribute, and are therefore in a position to provide counterparties with impartial and unbiased valuations of swaps. Furthermore, ITPPs typically apply a consistent valuation methodology across all clients and use multiple sources of price data. This not only tends to eliminate errors and any potential bias, but also allows them to value trades even in periods of illiquidity.

(iii) Unpredictable Changes

The Commission has proposed to require parties to include "complete alternative methods" for determining the value of a swap in the event that one or more relevant inputs become unavailable or fail.¹¹ In our experience, requiring counterparties *ex ante* to choose alternative inputs and valuation methodologies to be used for, by their very nature, unpredictable future circumstances seems difficult.¹² The same observation applies to situations where market conventions change or new pricing models establish themselves as market standard in the future given that they achieve a higher accuracy of pricing.

⁸ See *id.* at 6720.

⁹ See Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties; Proposed Rule, 75 Fed. Reg. 80638, 80659 (to be codified at 17 C.F.R. § 23.431(c)(3)(i)) ("the swap dealer or major swap participant is not required to disclose to the counterparty confidential, proprietary information about any model it may use to prepare the daily mark.").

¹⁰ For example, Markit provides clients of its Portfolio Valuations service with documentation that describes its pricing models, methodology and sources of market data inputs in detail. The market data that was used in the valuation is returned along with the valuation result in the standard results file.

¹¹ See Proposed Rule, 76 Fed. Reg. at 6719.

¹² For example, few if any market participants would have expected before the recent financial crisis that, given turmoil in the interbank lending market, there could ever be such widespread disagreement on how to compute a standard yield curve for an extended period of time.

We believe that the Commission needs to provide counterparties with a degree of flexibility to establish alternative methodologies in response to future events and organic development of markets. One way that the Commission could provide such flexibility is by explicitly allowing counterparties to define alternative methodologies by reference to the standards that are established and the valuations that are created by ITPPs. ITPPs adjust their pricing models and inputs as appropriate to reflect changes in market conventions and the occurrence of external events. Thus, counterparties can agree to specific alternative methodologies that are not only accurate and unbiased but also flexible regardless of what circumstances arise. Also, the Commission should note that market participants are used to delegating such tasks to ITPPs today. For example, many mutual funds in the U.S. solicit daily valuations from one or more ITPPs for use in calculating fund net asset value (NAV).

Therefore, we believe the Commission should permit market participants to mutually agree to reference the inputs, methods, procedures, and rules as provided by an ITPP in the documentation accompanying the execution of a swap, or to agree on using the actual swap valuation as provided by those independent third parties.¹³

3. The Commission Should Clarify that the Proposed Rule Would Not Require The Actual Verification of Valuation Methodologies By Third Parties.

The Proposed Rule explains that the methods, procedures, rules and inputs agreed to by the parties regarding swap valuations must constitute an “independently verifiable methodology”.¹⁴ We understand this to mean that the agreed-to methodology must be designed in a way that a hypothetical third party with access to all of the requisite documentation would be able to arrive at a substantially similar valuation. However, the rule could be read to imply that third parties or the Commission will routinely verify the valuation of a swap based on the agreed-to methodology, inputs and fallbacks. We are concerned that this would effectively eliminate the ability of SDs, MSPs, and any ITPPs to maintain the confidentiality of their proprietary information that is used in the valuation process.

We therefore request the Commission to clarify that requiring valuation methodologies to be “independently verifiable” is merely intended to guide parties in designing the methods, procedures, rules and inputs used to value each swap and would not essentially constitute public disclosure of their proprietary valuation methodologies.

4. The Proposed Rule Should Not Assign Primacy to Any Specific Source of Valuation Input.

Proposed Rule 504(b) states that, “[t]o the maximum extent practicable, the valuation of each swap shall be based on objective criteria, such as recently-executed transactions or valuations provided by independent third parties such as derivatives clearing organizations.”¹⁵ We agree that, to the maximum extent possible, the valuation of swaps should be based on objective criteria and inputs that are provided by independent third parties. However, by recommending that parties base their valuations on “recently-executed transactions”,¹⁶ the rule as written might unintentionally encourage parties to derive their valuations from a single input.

¹³ Swap trading documentation could state that “the counterparties to the swap mutually agree to utilize swap valuations as provided by ITPP “X”, and, having performed sufficient due diligence on X’s methods, procedures, rules, inputs and alternative methods, the parties mutually agree that these are acceptable for the purpose of valuing this swap.” If a higher degree of detail was required, the ITPP could provide the counterparties with documented methods, procedures, rules and/or inputs. Such document could be referenced as an addendum to the swap trading document.

¹⁴ See Proposed Rule, 76 Fed. Reg. at 6719.

¹⁵ *Id.* at 6726 (to be codified at 17 C.F.R. § 23.504(b)(4)).

¹⁶ *Id.*

As a provider of pricing and valuation services for swaps and cash instruments that are mainly traded over-the-counter, we will use the prices of recently-executed transactions as an input wherever they are available and appropriate. However, we believe that the valuation of a swap based on any single input will often lead to inaccurate results, and that for swaps that trade infrequently, “recently executed transactions” are no more of an independent or unbiased indicator of current value than other sources of pricing. Counterparties or third parties who produce valuations of infrequently traded products such as swaps will therefore routinely use multiple inputs for the valuation, will aim to understand the background of these prices, and will ultimately use judgment when deciding on the valuation of the product. Such approach has also been embraced by valuation experts.

We therefore recommend that the Commission clarify in the final rule that neither transaction prices nor any other single pricing input should necessarily be regarded by counterparties as the preferable input for the valuation of swaps. This applies only unless such a pricing input already takes numerous prices from different sources into account and exposes them to a sufficient level of scrutiny.

5. Parties to Cleared Swaps Should Be Permitted to Agree On the Use of ITPPs for Valuation Purposes.

The Proposed Rule refers to derivatives clearing organizations (“**DCOs**”) as independent third parties that provide valuations which could be used as objective criteria upon which to base the valuation of a swap.¹⁷ We agree that valuations provided by DCOs are useful. However, we do not believe that the Commission should necessarily require parties to exclusively use DCO valuations for swaps as the counterparties may prefer using valuations from other sources instead. This preference might even exist for cleared swaps, for the following reasons:

First, as the various DCOs use different methodologies and inputs for their daily swap valuations, their valuations for the same swaps will deviate. Second, counterparties that clear swaps with different CCPs (*e.g.*, clearing agencies registered under the Securities and Exchange Commission rules and regulations with respect to security-based swaps) and have positions also in swaps that are not centrally cleared have a strong interest in managing their valuation needs in an integrated fashion across all their positions. Third, some DCOs may not provide valuation dispute support¹⁸, which, in our experience, has been an important aspect of providing valuation services.

The use of valuations from ITPPs can address most of these issues. ITPPs apply a consistent methodology and utilize a consistent source of inputs for each individual swap instrument across all clients. Thus, two clients that hold otherwise identical swaps would receive identical valuations. Also, ITPPs will provide consistent and comparable valuations independent of whether they are cleared or not. Finally, most ITPPs are experienced at providing valuation dispute support and often have global teams dedicated to this function. Since many ITPPs compete in part on the quality of their customer support, they have developed technology and skill sets that allow them to quickly resolve disputes when any genuine pricing errors occur.

For these reasons, we believe that parties to cleared swaps may prefer to value such swaps based on sources other than the daily prices that are provided by the respective DCOs, and we request that the Commission explicitly permit parties to do so.

¹⁷ See *id.* at 6726 (to be codified at 17 C.F.R. § 23.504(b)(4)) (stating that, to the maximum extent possible, valuations “shall be based on objective criteria, such as . . . valuations provided by independent third parties such as derivatives clearing organizations.”).

¹⁸ Valuation dispute is a standard and important component of the valuation process. In the case that a counterparty receives a swap valuation and disagrees with it, counterparties must have a mechanism for disputing that valuation. A counterparty may wish to raise a dispute if the valuation it receives differs materially from its own view of the swap value. This could occur, for example, if the swap valuation was based on a significantly different input or assumption, or because an error occurred during the calculation of swap value.

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We appreciate the opportunity to provide these comments on this proposed regulation.

We thank the Commission for considering our comments. In the event you may have any questions, please do not hesitate to contact the undersigned or Marcus Schuler at marcus.schueler@markit.com.

Sincerely,

A handwritten signature in black ink, appearing to read "Kevin Gould", written over a light gray rectangular background.

Kevin Gould
President
Markit North America, Inc.