4th floor
Ropemaker Place
25 Ropemaker Street
London
EC2Y 9LY
United Kingdom

tel +44 20 7260 2000
fax +44 20 7260 2001
www.markit.com

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Mohamed Ben Salem
General Secretariat
International Organization of Securities Commissions (IOSCO)
Calle Oquendo 12
28006 Madrid
Spain

Submitted via CIS-Valuations@iosco.org

Re: **Consultation Report: Principles for the Valuation of Collective Investment Schemes**

Dear Sir/Madam:

Markit[1] is pleased to submit the following comments to IOSCO in response to its Consultation Report on the Principles for the Valuation of Collective Investment Schemes (the "***Consultation Report"*** or ***"CR***").[2]

Introduction

Markit is a provider of financial information services to the global financial markets, offering independent data, valuations, risk analytics, and related services across regions, asset classes and financial instruments. Our products and services are used by a large number of market participants to reduce risk, increase transparency, and improve the operational efficiency in their financial markets activities. We provide a large variety of clients with valuations for financial instruments across regions and products with a focus on products that trade over-the-counter and are hard to value.[3]

Executive Summary

The valuation of financial instruments often presents challenges for market participants.[4] We agree with IOSCO that the proper valuation of the assets held by Collective Investment Schemes ("***CIS***") is very important as a CIS must redeem and sell its shares at their net asset value. We believe that the establishment of IOSCO's Principles for the valuation of CIS (the "***Principles***") will be helpful to avoid situations where the calculated net asset value ("***NAV***") is not a fair representation of the value of the fund at the time of investors transacting in fund units. It will hence help protecting investors and treating them fairly.

Please find below our comments in relation to certain issues that we believe are relevant to ensuring the proper valuation of financial instruments by CIS. Our comments are based on our experience that ensuring the accuracy of valuations and creating sufficient transparency about underlying methodology, inputs, and

[1] Markit is a financial information services company with over 2,400 employees in Europe, North America, 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] *IOSCO Principles for the Valuation of Collective Investment Schemes,* IOSCO Consultation Report CR01/12, February 2012.
[3] Markit's Portfolio Valuations service currently provides around 70,000 swap valuations per day to its clients that include the leading fund administrators and investment managers. We provide valuations for individual swaps and SB swaps across all asset classes, including exotic products, as well as CCP settlement prices for Credit Default Swaps and credit indices.
[4] This is, amongst other reasons, because there is often neither a single methodology nor a single source of pricing data that would be appropriate for determining the fair value of every financial instrument.

major risks that are inherent in them will ultimately benefit CIS, their investors, their regulators, and the public. That said, we believe that it would be useful for IOSCO to be more specific in relation to certain elements of Principles 2, 8, 9, and 12. We believe that IOSCO should also consider issues related to the appropriate means of communicating valuations and related information.

Principle 2

a) Valuation methodologies

Principle 2 requires CIS to identify the methodologies that they use for valuing each type of asset held or employed by the CIS, including the inputs, models, and selection criteria for pricing and market data sources, having regard to sound and reliable data.[5] While the CR provides some guidance for valuation approaches for the easier-to-value financial products,[6] it stays quiet on what the expectations are for hard-to-value assets where such questions are even more relevant. Accordingly, we believe that IOSCO should consider adding the below considerations to Principle 2.

- **Valuations should be based on multiple, observable inputs where available**

For actively-traded financial instruments, such as certain exchange-traded products, a reliable price can often be readily and accurately ascertained based on market quotations. In contrast, for financial instruments that do not trade actively or trade mainly over-the-counter, market quotations are often not readily available. Based on our experience, valuations for such products will be most accurate and reliable if several (or ideally all) available sources of observable data are utilized.[7] This is because such approach will help avoid the need to model inputs, to extrapolate, or to introduce any unnecessary assumptions. We believe that such guidance should be included in the Principles. Further, the Principles should also ensure that investments in unlisted assets are properly valued. This could, for example, be achieved by the use of market proxies or management assumptions.

- **Valuations should reflect inherent risks**

We believe that valuations should reflect the relevant risk factors that impact their value, including 2^{nd} or 3^{rd} order risks. For example, for positions in derivatives, valuations should reflect factors such as a) counterparty exposure, b) the correlation between the asset underlying the derivative and the counterparty of the derivative contract (where this effect is significant), and c) potential gains or losses based on future market moves.[8] This could, for example, be quantified by using concepts such as Potential Future Exposure (PFE) or Credit Value Adjustments (CVA).

b) Liquidity

As part of the general practices for valuing the CIS's assets, the IOSCO Principles state that, for hard-to-value assets, the portfolio manager of the CIS should monitor the market's liquidity.[9]

We agree with IOSCO that the liquidity of a position in a financial instrument is an important factor as it can have a direct impact on the price and the speed at which such position can be liquidated. Unfortunately, the

[5] IOSCO CR Principle 2: *The policies and procedures should identify the methodologies that will be used for valuing each type of asset held or employed by the CIS*.
[6] "Assets should, where possible, be valued according to current market prices, provided that those prices are available, reliable, and frequently updated". IOSCO CR Principle 2.
[7] If no observable data is used, the modelling of inputs or the discounting of expected future cash flows might be necessary.
[8] Such risk measure would be useful because the value of the derivative could change significantly over the life of the contract and a current exposure based approach may underestimate the risk of the derivative contract.
[9] "Frequently, hard-to-value assets tend to be illiquid (with a very limited or no secondary market). In this respect, a CIS portfolio manager should monitor the liquidity in markets in which the CIS is invested as part of a liquidity management policy." IOSCO CR Principle 2.

measurement of liquidity of financial products is a challenging task, not only at a given point of time, but also because liquidity conditions evolve over time. While the approximation of liquidity by the use of trading volumes might be appropriate for the limited number of very liquid exchange-traded products, we have found that "prospective" liquidity, the likelihood of being able to sell a position in the product equal or close to the current market price, is best suited to measure the liquidity of financial instruments that trade mainly over-the-counter.[10] Our experience[11] has shown that measures of prospective liquidity can be derived from a combination of observable market, product, and firm specific factors. These factors include, for example, quoted bid/offer spreads, market depth and resilience, trading volumes, the positions and counterparties of the specific firm, average transaction size, and the number of market makers.

Given the importance of a product's liquidity from a risk and valuation perspective, it would be beneficial if CIS were to quantify and disclose the liquidity of their positions in addition to their valuation.[12] Such disclosure would enable CIS themselves, their investors, and their regulators to develop a better understanding of the liquidity risks that individual CIS are exposed to. In order to measure liquidity, we believe that IOSCO should permit CIS the use of criteria-based, quantitative approaches that are likely to be more accurate, useful, dynamic, and easier to implement than any centrally administered approach.[13]

c) Transparency

Principle 2 of the CR states that the Responsible Entity, when using third parties, should "assess and understand the methodology and parameters on which the opinion was produced".

As a provider of valuations, we aim to supply our clients with sufficient information to enable them to understand the underlying assumptions and explain how the valuation was produced. To achieve such objective for all CIS, we believe that third-parties should be required to provide technical documents that contain information on the nature of the inputs, the valuation techniques, and the assumptions and details of the pricing models that they use in producing their valuations. Further, to facilitate implementation, it might be useful for the IOSCO Principles to contain a standard set of "transparency parameters" that would be provided by third parties to CIS alongside the actual valuations.[14]

Our experience has shown that the use of a multi-dimensional perspective on valuations is crucially important. It would therefore be beneficial for CIS to be provided with sufficiently detailed information about the inherent risk of the valuations that they receive from third parties. As any valuation contains some level of uncertainty, measures of inherent valuation uncertainty should be provided to CIS regardless of whether the underlying product is exchange-traded, centrally cleared, or traded purely OTC.[15]

Importantly, CIS as recipients of valuations should not only be in a position to understand and explain how these valuations were produced, but they must also be able to challenge them. If they decide to do so, the vendor should provide the CIS with details of a thorough investigation on a timely basis. The vendor should also make its valuation experts available to discuss its underlying assumptions and results with the client in detail.

Principle 3 – Conflicts of interest

[10] It is worth noting that IOSCO, in a recent report, endorsed prospective liquidity as a means of determining market liquidity. See IOSCO Task Force on OTC Derivatives Regulation, Report on Trading of OTC Derivatives, 26-29, *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD345.pdf.

[11] Markit currently provides liquidity metrics and scores for CDS, asset-backed securities, bonds, municipal bonds, and loans.

[12] However, we believe that requiring such measurement of liquidity for unlisted investments would be less appropriate given their expected long holding periods.

[13] For example, regulatory authorities could consider assigning financial instruments to certain liquidity buckets. However, such approach would not only be challenging to administer but it would also be rather static and therefore often outdated.

[14] Such parameters should be designed to also be sufficient to enable an auditor to provide a positive or negative assurance on the appropriateness of the valuation.

[15] See International Valuation Standards Council's ("IVSC") Discussion Paper "Valuation Uncertainty," September 2010; IVSC Standards Board Meeting, 3 Nov. 2011; Financial Services Authority Consultation Paper "Proposed Regulatory Prudent Valuation Return," Dec. 2011.

The repeated occurrence of significant "trading losses" that are related to inaccurate (or manipulated) valuations highlights the need for users and regulators alike to protect valuations against exposure to conflicts of interest. We believe that the risk of valuations not representing fair value will persist as long as the holders of hard-to-value positions can influence, in one way or another, where these positions are valued. We therefore agree with IOSCO[16] that, to ensure the accuracy of CIS's valuations, it is important for them to properly manage conflicts of interest. We also share IOSCO's view that one way to address such conflicts is to require for funds' valuations to be "independent", a requirement which has to some extent has already found its way into today's industry best practice.[17]

Valuations will typically be regarded as independent if they are provided either by separate units of the fund or by independent third-party providers ("***ITPPs***"). ITPPs do not trade or take positions themselves and therefore have no financial interest in the valuations that they distribute to their users. Further, the valuations that they provide tend to offer several additional advantages to funds, their investors, and their regulators. For example:

- ITPPs typically use multiple sources of pricing such as exchanges, CCPs, counterparty marks and independent pricing services. They are therefore able to eliminate most errors and bias to create a representative view of the appropriate valuation

- ITPPs are experienced in developing, calibrating, and deciding on appropriate valuation models[18]

- Many ITPPs offer substantial transparency into the methods and inputs that they used to produce valuations as well as their inherent risks[19]

- Many ITPPS have established procedures to provide valuations as of specific snap times as requested by the client.[20]

Many CIS already make use of independent third party valuations today for their positions in derivatives and other financial instruments. Because of the benefits described above and the elimination of conflicts of interests resulting from the use of independent sources, there might be benefits in requiring CIS to use independent sources for the valuation of their positions in financial products. CIS could satisfy such requirement by using valuations that are provided either by an independent unit of the fund or by one (or several) ITPPs.

Principle 8 – External review of the valuation process

The IOSCO Principles require that "a third party should review the CIS's valuation process at least annually".[21] We believe that such reviews would be beneficial as they would allow the CIS to benchmark their valuation process to those of the broader valuations industry. They will also be helpful to ensure that their process remains current and per best practice.

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[16] IOSCO CR Principle 3.

[17] See, for example, AIMA Guide to Sound Practices of Valuation, March 2007; Circular to notify undertakings for collective investment in transferable securities (UCITS), August 2007

[18] The use of a valuation model is necessary to produce a valuation for most swaps, and the choice of an appropriate model will therefore impact the reliability of the resulting valuations. While Markit tends to use industry standard pricing models, the regular re-calibration of such models to observed prices, the active monitoring of price challenges and the ongoing dialogue with industry participants ensures the consistency of these models with industry standards. Often, the timely adjustment of valuation methodologies will be required to reflect distressed markets or changes in industry pricing practices.

[19] For example, we will provide our clients with documentation that creates transparency around the inputs, valuation techniques and assumptions that we use in producing our valuations.

[20] In our experience, most CIS calculate their NAV and hence the price at which investors can buy/redeem shares, as of a specific time during the day. It is therefore vital that the valuation of their derivatives positions is performed as of this time.

[21] IOSCO CR Principle 8.

Principle 9 – Due diligence on third party valuation providers

We agree with IOSCO that, where the CIS appoints a third-party to provide valuation services, it should conduct due diligence to determine whether the service provider has appropriate systems, controls, and valuation policies in place.[22]

We believe that, in order to comply with such due diligence requirement, a third-party should provide the Responsible Entity with a) documentation providing reasonable assurance that the valuation process is executed consistently, and b) an agreement between the parties relating to the service which includes service levels to provide users of the service with sufficient assurance that the results will be provided to an agreed schedule of requirements. By implication, these documents would evidence that the third-party has the competence and resources necessary to meet its obligations. We further believe that, to facilitate CIS's compliance with such requirement, it might be useful for the Principles to clarify that an appropriate certification obtained by the services provider, for example a SSAE 16 (formerly SAS 70) certification, would be acceptable to demonstrate compliance with the due diligence requirement.

That said, we agree with IOSCO that the ultimate responsibility for the accuracy of the valuation of the CIS's portfolio (and hence its NAV) will ultimately always have to be with the CIS.[23] This is justified for a number of reasons:

- Third party valuation providers will typically provide the CIS only with an indicative mid price on an instrument basis. However, the actual level where a CIS's position is eventually valued will typically include further adjustments to reflect, for example, the size of the position, the bid/offer spread, counterparty risk, and other idiosyncratic factors. Such adjustments will generally be made by the CIS itself or by its fund accounting agent based on the fund's pricing policy. This holds true regardless of the level of subjectivity of the valuation provided.[24]

- According to current market practice, any valuation service will only provide an indication of current value for an instrument, which might or might not be used by the CIS when it decides where to value the actual position. Third party valuation providers will rarely know their ranking within a CIS's pricing policy and whether their valuation was used in the calculation of a particular day's NAV.

- Third party valuation providers tend to receive information only for the instruments that they are asked to value and will not generally know the composition of the fund's entire portfolio. Even though they provide pricing/valuation information that the CIS might use to calculate and ensure the quality of the NAV, they are therefore fully removed from the actual NAV calculation and the syndication of the share price to fund investors.

Principle 12 – Valuation frequency

We agree with IOSCO's expectation that the CIS's portfolio should be valued on "any day that CIS units are purchased or redeemed".[25] That said, we believe that it could be useful for the Principles to be more specific in relation to the exact timing of the valuation.

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[22] IOSCO CR Principle 9.
[23] [T]he Responsible Entity retains responsibility and liability for the valuations of the CIS's assets." IOSCO CR Principle 9.
[24] For example, 3rd party valuations of private equity investments that are based on quantitative models will generally not reflect factors such as key person risk, the risk of fraud, or control issues. The impact of these elements would typically be taken into account by the CIS itself.
[25] IOSCO CR Principle 12.

We believe that, to protect investors of the fund, any requirement in relation to the timing of valuations should be specific enough to ensure that the resulting NAV is as accurate as possible. IOSCO should note that, with this objective in mind, funds in some jurisdictions are required to use “readily available” market quotations when calculating their NAV[26] and, where market quotations are not readily available at that time, to value the relevant securities at “fair value”.[27] On this basis the prices that are used for the valuation of the fund’s positions will be most representative of exit value *at the time of the NAV calculation* and will take into account all information that is available to market participants at that time.

Means of communicating valuation information

Our experience in providing valuations has shown that there is a need for the means used to communicate valuation information between CIS and third parties to be sufficiently secure and auditable. Such qualities are required not only to secure the confidentiality of the client’s position information but also to enable the monitoring of potential valuation disputes and their resolution.[28]

We note that the IOSCO principles are quiet on how the relevant information needed to perform a valuation would be communicated from the CIS to the third parties, and how the resulting valuation data would be communicated from the third parties back to the CIS. We believe that there might be reason for the IOSCO principles to address the issue of “means of communication” in order to avoid any unnecessary risks. Specifically, to secure the confidentiality of transaction information and to enable the monitoring of price challenges and their resolution, CIS should use means of communication that are sufficiency secure and auditable. We believe that the interfaces used for communicating valuation information should provide the CIS and third-parties with tools to initiate, track and close valuation disputes. They should also be designed to prevent any unintentional or fraudulent addition, modification, or deletion of a valuation record.

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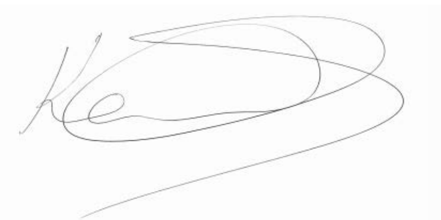
We appreciate the opportunity to comment on IOSCO’s Consultation Report on the Principles for the Valuation of Collective Investment Schemes, and we thank IOSCO for considering our comments. In the event you may have any questions, please do not hesitate to contact the undersigned or Marcus Schüler at marcus.schueler@markit.com .

Yours sincerely



Kevin Gould
President
Markit North America, Inc.

[26] Required by the SEC in the United States. See Investment Company Act of 1940 Section 2(a)(41)(B).
[27] For instruments that do not trade at the time of the valuation, such “fair value” might be computed, for example, by the use of statistical factor models.
[28] For Markit’s Portfolio Valuation Services, for example, transaction details are communicated by secure data feeds that are generated from the client’s accounting and portfolio management systems, from Markit Valuations Manager, or from trade confirmation platforms. The use of such feeds is not only convenient for clients, but also ensures that the submitted data that is used to perform the valuation is indeed both accurate and complete.