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25 May 2012

National Treasury of the Republic of South Africa
120 Plein Street
Cape Town
South Africa

Submitted to lusanda.fani@treasury.gov.za

Re: **Reducing the risks of OTC derivatives in South Africa**

Dear Sir/Madam:

Markit[1] is pleased to submit the following comments to the National Treasury of the Republic of South Africa (the "***Treasury***") in response to its Concept Paper *Reducing the risks of over-the-counter derivatives in South Africa* (the "***Concept Paper***" or "***CP***").[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]

In South Africa, Markit has provided data and valuations services to local banks for a number of years. All major local dealers contribute to some of the derivative-related services that provide OTC derivatives market makers with consensus-based valuations. The service encompasses the equity, interest rates, currency, commodity, credit, property and bond markets, providing matrices of vanilla prices and a wide selection of exotic products. Many local banks also use our credit and reference data to monitor daily risk, to support the marking-to-market of their positions and to develop accurate forecasting services.

Markit has been actively and constructively engaged in the debate about Regulatory Reform of the global OTC derivatives markets and the implementation of the Pittsburgh G20 commitments.[4] Over the last 18 months we have submitted 29 comment letters to regulatory authorities around the world and we have participated in numerous roundtables. We regularly provide the relevant authorities with our insights on current market practice, for example in relation to valuation methodologies, the provision of scenario analysis, or the use of reliable and secure means to provide daily marks. We have also advised regulatory authorities on appropriate approaches to enabling a timely and cost-effective implementation of newly

[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] National Treasury of the Republic of South Africa: Reducing the risks of over-the-counter derivatives in South Africa. 27 March 2012.
[3] Markit's Portfolio Valuations service currently provides around 70,000 OTC derivatives valuations per day to its clients that include the leading fund administrators and investment managers. We provide valuations for OTC derivatives across all asset classes, including exotic products, as well as CCP settlement prices for Credit Default Swaps and credit indices.
[4] "Leaders' Statement: The Pittsburgh Summit" (Sept. 24-25, 2009), available at http://www.g20.org/pub_communiques.aspx.

established requirements, for example through the use of multi-layered phase-in or by providing participants with a choice of means for satisfying regulatory requirements.

Please find below our comments in relation to certain issues that we believe are relevant to reducing the risks of OTC derivatives. Specifically our comments relate to valuation methodologies, including the frequency of valuations, the reporting of valuations to Trade Repositories ("***TRs***"), and the ownership of data reported to TRs.

Question 3: Which of these provisions should the code of conduct include?

The CP mentions "valuation methodologies" as one of the provisions that the code of conduct might include, while the CP also asks specific questions in relation to the valuation of OTC derivatives.[5] We believe that, given the importance of proper valuation of positions in OTC derivatives both from a micro- and a macro-prudential perspective, it would be useful for the Treasury to include valuation methodologies in its code of conduct. We further believe that, in line with the approach that was taken in other jurisdictions, the Treasury might consider introducing requirements both in relation to how transactions in OTC derivatives are valued internally and whether and how "marks" for positions in OTC derivatives are provided by dealers to their counterparties.[6]

The valuation of OTC derivatives can be complex and challenging. Given the large variety of products and the many possible approaches to valuing them, we generally believe that any code of conduct in relation to valuation methodologies should only set high level principles and encourage firms to use their judgment. It should also follow internationally established best practice by, for example, requiring firms to maximize the use of observable inputs into valuation,[7] ensuring that they have a thorough understanding of models and inputs, and that they actively manage conflicts of interest by ensuring the independence of valuations.

Also, to promote greater transparency of valuation methodologies and foster the impartiality of valuations the Treasury should permit the delegation of any obligation to perform internal valuations or provide daily marks to counterparties to appropriately qualified independent third party providers ("***ITPPs***"). This would mirror the approach used in other jurisdictions when designing business conduct standards and valuation standards for OTC derivatives.[8] Valuations that are provided by ITPPs are based on objective and independent inputs, allowing them to provide the counterparties with impartial and unbiased daily marks. 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 period of illiquidity. Most importantly, ITPPs are not trading entities and therefore have no direct financial interest in the prices they distribute. They are therefore in a position to provide a higher level of transparency around the inputs and models that they used to produce a valuation. ITPPs are generally able to provide their clients with details of the pricing models that they used, the nature of the data inputs such as curves, volatilities, correlations, or dividends and other assumptions introduced into the valuation process. Daily marks as provided by ITPPs can therefore potentially create an increased level of transparency in the valuation process, while alleviating parties to the OTC derivative transaction from any requirement to disclose their proprietary information.[9]

Question 20: Should data reported by market participants be regarded as market participants' data or owned by the repository? If the former, should reporting entities and counterparties be charged a fee for accessing their own data?

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[5] Please find our response to questions 43 and 44 below.
[6] Business Conduct Standards for Swap Dealers and Major Swap Participants, 77 Fed. Reg. 9734 (Feb. 17, 2012).
[7] The use of observable data will reduce the need for "marking to model", extrapolation, or other techniques that add further uncertainty into the valuation process.
[8] Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 77 Fed. Reg. 9734 (Feb. 17, 2012)
[9] 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.

We believe that the Treasury should take the following considerations into account when making determinations in respect to the ownership of the data that has been reported to a TR:

- The task of TRs is to receive, store, and make available accurate data of OTC derivatives transactions. TRs should not be conflicted by attempting to monetize the data that they receive and they should only be permitted to do so if they received the permission from the reporting parties.
- TRs need to generate revenues to enable them to perform their services. They should therefore be permitted to charge the reporting parties on a fair and not unreasonable basis. They should also be allowed to offer data services in relation to data that they have made publicly available.[10]
- Counterparties that report transaction data to the TR should be able to access the data that they have reported without any unreasonable restrictions being imposed on them.
- Third parties, such as providers of confirmation, multilateral compression or data services, might need to access the TR data to perform post-trade processing or data-related services. TRs should be required to provide open, non-discriminatory access to such third party providers. However they will need to receive permission from the reporting parties before they can provide the data.

We believe that such approach would be very much in line with other jurisdictions.

Questions 42 to 44: What level of transactional data should be reported to the repository? What level of valuation data should be reported to the repository? What level of aggregate data should be reported to the repository?

We note that significant progress has been made in establishing TRs globally and tasking them with capturing accurate position and/or transaction information for OTC derivatives by region and/or asset class. However, we agree that gaps still exist in relation to the information and tools that are available to regulatory authorities which might prevent them from making full use of the TR data for systemic risk analysis.[11] One of these gaps is the availability of valuation data.

When comparing the various options of how to address this "data gap", we recommend the Treasury reviews whether an option allows it to achieve its regulatory objectives in a timely fashion, whether the means of communication used are sufficiently secure and efficient, and whether it avoids the creation of unnecessary costs for market participants and TRs. That said we believe that the Treasury's objectives in terms of receiving information about current market values of outstanding OTC derivatives contracts can be best achieved if a) one uses counterparty marks as indicator of current market values for OTC derivatives; and b) one tasks TRs with collecting such marks from the counterparties and providing them to regulators.

Firstly, we believe that counterparty marks should be used as indicators of current valuation. For centrally cleared OTC derivatives, the daily settlement price provided by the relevant CCP seems a good starting point to measure current market value for regulatory purposes. However, several CCP prices might often exist for the same product. Also, some regulatory authorities have determined that they do not want to rely on the CCP's daily settlement price as the sole indication of current valuation and hence require counterparties to report their valuations for cleared OTC derivatives to TRs.[12] For those OTC derivatives transactions that are not centrally cleared, one could source indications of current market value from the counterparties to the transaction, from independent valuation providers, or from other sources.

Secondly, we recommend that the Treasury aim to receive current market values (based on counterparty marks) directly from TRs. Such approach will be more efficient than for the Treasury to obtain marks directly

[10] This would be in line with the approach taken in the United States. Real-Time Reporting of Swap Transaction Data, 77 Fed. Reg. 1182 (Jan. 9, 2012).
[11] CPSS/IOSCO identified existing data gaps as (i) accurate valuation data, (ii) bilateral portfolio data (e.g. net notionals based on aggregation, netting, master agreements, collateral, and margin information), and (iii) collateralisation (depending on nature of collateral, valuation, custody, legal framework).
[12] Swap Data Recordkeeping and Reporting, 77 Fed. Reg. 2136 (Jan. 13, 2012).

from individual counterparties given the relatively limited number of TRs. We believe that it will be much easier for the Treasury to establish connectivity with TRs, as opposed to the whole range of individual counterparties. Finally, we believe that counterparties to OTC derivatives transactions would also prefer this method because it will enable them to make use of established, scalable means to communicate their marks to TRs in an efficient, secure, and auditable manner.

Question 57: Should changes in valuation for all OTC derivative transactions be reported on a daily basis? If not, how often should valuation changes be reported?

Daily marking-to-market of positions in OTC derivatives has established itself as best practice for active users of these products globally.[13]

We therefore believe that changes in valuation for all OTC derivative transactions, both cleared and uncleared, should be reported to the TR on a daily basis by active market participants. This would also be in line with other jurisdictions' regulations regarding valuation data reporting.[14] However, as has also been reflected in requirements in other jurisdictions, any requirement to report valuations should be less frequent for smaller, less active market participants, e.g. non-financials or end-users.

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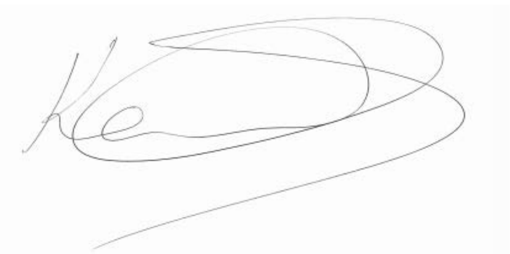
Markit appreciates the opportunity to comment on the Treasury's Concept Paper *Reducing the risks of OTC derivatives in South Africa*. We would be happy to elaborate or further discuss any of the points addressed above. In the event you may have any questions, please do not hesitate to contact the undersigned or Marcus Schüler at marcus.schueler@markit.com.

Yours sincerely



Kevin Gould
President
Markit North America, Inc.

[13] Business Conduct Standards for Swap Dealers and Major Swap Participants, 77 Fed. Reg. 9734 (Feb. 17, 2012); Swap Data Recordkeeping and Reporting, 77 Fed. Reg. 2136 (Jan. 13, 2012); European Market Infrastructure Regulation (EMIR).
[14] Real Time Public Reporting of Swap Transaction Data, 77 Fed. Reg. 1182 (Jan. 9, 2012)