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February 22 2013

Securities and Exchange Commission
Attn: Elizabeth M. Murphy, Secretary
100 F Street, N.E.
Washington, DC 20549-1090
Rule-comments@sec.gov

Re: Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants for Capital Requirements for Broker-Dealers

Dear Ms. Murphy:

Markit[1] is pleased to submit the following comments to the Securities and Exchange Commission (the "***SEC***" or the "***Commission***"), in response to its Proposed Rule regarding *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants for Capital Requirements for Broker-Dealers* (the "***Proposed Rule***").[2]

Introduction

Markit is a provider of financial information services to the global financial markets, offering independent data, valuations, risk analytics for internal capital models, and related services across regions, asset classes and financial instruments. Our products and services are used by numerous market participants to reduce risk, increase transparency, and improve the operational efficiency in their financial markets activities.

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.[3] Over the past 3 years, we have submitted more than 40 comment letters to regulatory authorities around the world and have participated in numerous roundtables. We also 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 mid-market marks. We have also advised regulatory authorities on appropriate approaches to enabling a timely and cost-effective implementation of newly established requirements through the use of multi-layered phase-in or by providing participants with a choice of means for satisfying regulatory requirements. On the topic of margin requirements for uncleared derivatives, we have previously submitted comment letters to the CFTC, BCBS IOSCO, and the US Prudential Regulators.[4]

[1] Markit is a financial information services company with over 2,900 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] Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participant ants and Capital Requirements for Broker-Dealers. 77 Fed. Reg. 70214 (November 23, 2012).
[3] "Leaders' Statement: The Pittsburgh Summit" (Sept. 24-25, 2009), *available at* http://www.g20.org/pub_communiques.aspx.
[4] Markit letter to the CFTC regarding the proposed rule "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants (September 14, 2012) *available* here. Markit letter to BCBS IOSCO on Margin requirements for non-centrally-cleared derivatives (September 28, 2012) *available* here*.* Markit letter to the Prudential Regulators regarding the proposed rule "Margin and Capital Requirements for Covered Swap Entities" (Nov. 26, 2012), *available* here.

Executive Summary

Markit provides participants in global financial markets with state-of-the-art analytical services across asset classes, often in conjunction with our pricing and valuation services. These services support, for example, banks (including those that have received or are expecting to receive IMM approval) with the calculation of their regulatory capital requirements, including measures such as PFE, IMM EAD, IRC, CRM, and the CVA Capital VaR charge.[5] Based on our expertise in these areas, we have been approached by numerous buy-side and sell-side institutions to help them address upcoming challenges related to the calculation of initial margin ("***IM***") and variation margin ("***VM***") for their portfolios of cleared and uncleared derivatives transactions.

We welcome the SEC's Proposed Rule in light of the publication of BCBS IOSCO's Second Consultative Document on *Margin requirements for non-centrally cleared derivatives*[6] and the proposals from the CFTC and the US Prudential Regulators, and we appreciate the opportunity to provide our comments. We believe that mandatory margining for uncleared security-based swaps and uncleared swaps could significantly impact the functioning and, potentially, the stability of financial markets due to the resulting operational challenges and demands on liquidity and collateral. Our recommendations therefore are aimed at ensuring that such margin calculations appropriately reflect the degree of risk posed by various derivative transactions and at facilitating an operationally efficient and timely implementation of the margin requirements.[7]

Specifically, we believe that the SEC should: (1) ensure that a large number of buy-side and sell-side counterparties are able to use approved IM models, including models that are provided by third parties; (2) allow counterparties to agree to have a third party provider calculate their respective IM amounts or to base their IM calculations on inputs and calculation methodologies as provided by such third party; (3) allow for choice between the use of model-based and grid-based approach to IM calculation on a sufficiently granular level; (4) clarify the frequency with which IM and VM calculations and collection will be required; and (5) permit counterparties to reference dispute resolution methods, valuations, or inputs in relation to VM calculations.

Furthermore, we believe that, in general, the SEC should seek to strike an appropriate balance for the margin requirements applicable to cleared and uncleared security-based swaps (whether they be uncleared because of their customized nature or due to the end-user exception). Cleared and uncleared security-based swaps both serve their purposes, and we believe that margin rules should leave sufficient room for appropriate contractual arrangements to take place between the parties.

Comments

1. The SEC Should Approve IM Models Developed and Supported by Third Parties in a Manner that Facilitates their Broader Use

The Proposed Rule allows security-based swap dealers ("***SB-SDs***") and major security-based swap participants ("***SB-MSPs***") to choose between using a standardized method and a model-based method for calculating the margin amount.[8] Similarly, BCBS IOSCO offered parties the choice between using a model-based Quantitative Portfolio Margin Model ("***QPMM***") or the grid-based Standardized Initial Margin

[5] CVA = Counterparty Value Adjustment, PFE = Potential Future Exposure, IMM EAD = Internal Model Method Exposure At Default, IRC = Incremental Risk Charge, and CRM = Comprehensive Risk Measure.
[6] Basel Committee on Banking Supervision & Board of the International Organization of Securities Commissions, Margin requirements for non-centrally-cleared derivatives (February 2013) [hereinafter the "***BCBS IOSCO Consultative Paper***"], *available at* http://www.bis.org/publ/bcbs242.pdf.
[7] We do not express any views herein on many of the more fundamental elements of the IM/VM regime, such as the categories of counterparties that should be required to collect or post margin or whether and how thresholds should be used.
[8] *See* Proposed Rule, 77 Fed. Reg. at 70261.

Schedule, and bank SBSDs and bank SDs would have the option of using internal models to calculate initial margin requirements under the rule proposed by the Prudential Regulators.[9] Generally speaking, the model-based approaches would apply a set formula to each security-based swap or portfolio of security-based swaps, while the grid-based approaches would approximate margin requirements based on a schedule setting forth margin requirements as a percentage of notional exposure.

We generally support the use of risk-based models for IM calculation over any grid-based approach so long as the risk-based models are sufficiently robust and accurate. IM calculations derived from grid-based approaches are generally solely based on the asset class, maturity, and notional amount of a security-based swap, which we believe is unlikely to accurately reflect the risk of such security-based swaps. Grid-based approaches will therefore likely result in inappropriate IM amounts that will be too great for some uncleared security-based swaps, thereby locking up a limited supply of collateral that could be used more productively, or too small, thereby not sufficiently mitigating risk. Further, since grid-based approaches generally treat every transaction on a stand-alone basis and not allow for any portfolio offsets to be applied, they would result in higher overall IM amounts for portfolios of uncleared security-based swaps.

However, we believe it might take a significant amount of time before market participants will be in a position to use IM models because they would need to dedicate significant resources to develop them and receive approval from the relevant regulatory authority.[10] Moreover, regulatory authorities may not have the resources necessary to accommodate a wave of requests by individual firms for IM model approval in a timely fashion.[11] As a consequence, many market participants could be forced to rely on the standardized method approach for the foreseeable future. In addition to other consequences, we believe that such situation could place those market participants at a competitive disadvantage as they would have to collect significantly higher IM amounts from their counterparties vis-à-vis their competitors that received approval to use model-based calculations.[12] This could, in the extreme, prohibit some counterparties from actively participating in the market and lead to a concentration of risk around the counterparties that have received internal model approval.

The Commission asked whether market participants should be permitted to use IM models available for licensing by vendors.[13] Consistent with BCBS IOSCO's view[14] we believe that the Commission should provide market participants with the flexibility of using either an internally developed or a third party provided model as it would provide several benefits, for example facilitating a timely and cost effective implementation. We further believe that permitting a broader set of market participants to use the same model (and/or IM calculations that are based on the same inputs and scenarios) created by a third party vendor and approved by the Commission would address many of the tensions discussed above, and therefore should be permitted. Specifically, such approach would provide the following benefits:

- A larger number of counterparties, both buy-side and sell-side, would be able to use a model-based approach much earlier. This would result in the calculation and collection of IM amounts that are more

[9] *See* BCBS IOSCO Consultative Paper, Element 3: Baseline minimum amounts and methodologies for initial and variation margin; *see also* Prudential Regulator Margin and Capital Proposing Release*,* 76 Fed. Reg. at 27567–27568.
[10] BCBS IOSCO would also require each individual firm to receive approval from its regulator before using a QPMM. BCBS IOSCO Consultative Paper at 11 ("There will be no presumption that approval by one supervisor in the case of one or more institutions will imply approval for a wider set of jurisdiction and/or institutions.").
[11] As of February 19, 2013, the CFTC reported that 71 entities have registered as swap dealers. We believe it is likely that a similar number will register with the SEC as SB-SDs and it may be difficult for the Commission to review and approve this many requests with its limited resources.
[12] *See* 77 Fed. Reg. 70317 (Nov. 23, 2012) ("To what extent will firms that receive approval to use VaR models be able to dominate trading in security-based swaps, whether because of costs to other firms in applying a haircut methodology to security-based swaps or for other reasons?").
[13] *See* Proposed Rule, Question # 7, 77 Fed. Reg. at 70262.
[14] BCBS IOSCO Consultative Paper at 11 ("Models may either be internally developed of may be provided by the counterparties and third party vendors but in all such cases these models must be approved by the appropriate supervisory authority.").

reflective of the actual risk posed by the specific uncleared security-based swap transactions in a portfolio context, compared to those determined by the standardized grid-based method. It would therefore reduce the overall liquidity and collateral demand in the financial system, as well as the cost of the margin regime for counterparties.

- It would avoid creating an unlevel playing field between larger and smaller regulated entities that are competing for business in the marketplace, since not all regulated entities will have sufficient resources to develop and receive approval for their own internal models and they would be forced to use the (disadvantageous) grid-based approach if the Commission was not to allow a broader use of approved models.

- It would significantly reduce the overall time and resources required of the Commission to approve IM models. It would speed up the implementation of the new margin regime while also reducing the demands on the scarce resources of the Commission. This would be true not only in the initial approval stage but also for ongoing monitoring and analysis thereafter.

- Over time, we would expect a limited number of standard inputs, models and methodologies for IM models provided by qualified third parties to emerge. Given the expertise and insights that regulatory authorities, including the Commission, will develop during the approval process of such models, these models and methodologies will be well understood by regulatory authorities, thereby increasing transparency and supporting their oversight capabilities. Further, the emergence of some standardized approaches to the calculation of IM for categories of uncleared security-based swaps will be beneficial in preparing them to be centrally cleared.

We agree that the use of an IM model should generally be subject to an appropriate internal governance process.[15] However, we believe that, with this limitation, the Commission's approval of specific margin models for use by a broader range of buy-side and sell-side counterparties based on a simplified application and approval process would be appropriate because, unlike capital requirements, margin requirements are transaction-based and require more limited firm-specific input or judgment. We also believe that third party providers of risk-based IM models (such as Markit or other, competing providers) can provide the Commission with the necessary transparency around their models, methodology, and inputs. Further, such third parties would establish appropriate governance and business continuity procedures for the operation of their IM models. We believe that third parties acting within this framework will help to ensure the accuracy, timeliness, and independence of the IM calculations while also allowing for an effective and efficient implementation. We are open to discussing these issues with the Commission in further detail to ensure that regulatory expectations can be met.

We believe that the Commission, as well as other regulatory authorities, could most effectively approve the use of a third party provided IM model based on a joint application from the firms that want to make use of such approach. Ideally, given the international nature of the derivatives markets, the approval process would be conducted jointly by the relevant regulatory authorities and a model approval would therefore apply across jurisdictions. Any third party that offers these services should provide the Commission and other relevant regulatory authorities with sufficient transparency about its models, inputs, governance, and procedures as explained in more detail above.

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[15] BCBS IOSCO Consultative Paper at 11 ("Second, quantitative initial margin models must be subject to an internal governance process that continuously assesses the value of the model's risk assessments, tests the model's assessments against realized data and experience, and validates the applicability of the model to the derivatives for which it is being used.").

Finally, we believe that approval and use of third party models could also apply to the calibration of haircuts that might also be required as part of the margin regime.[16]

2. The Commission Should Minimize the Potential for Disputes on IM Amounts by Permitting Both Counterparties to a Transaction to Delegate IM Calculation to an Agreed-Upon Third Party or to Base their IM Calculation on a Set of Inputs and Methodologies Provided by Such Third Party

Under the proposed margin rules, counterparties will be individually responsible for calculating the respective IM amounts that they would collect from their counterparties. Many market participants, both buy-side and sell-side, are concerned not only about the operational challenges and significant cost that this approach would create, but also about the numerous disputes that are likely to arise between the counterparties on that basis. Importantly, from the perspective of the Commission, disputes on IM could result in delaying IM collection, thereby creating systemic risk. We do not believe that this problem can be adequately addressed by policies and procedures for dispute resolution and portfolio reconciliation because these procedures will only address a dispute once it has already arisen.

BCBS IOSCO recognized[17] that the risk of disputes on IM could be significantly reduced by permitting the counterparties to agree, prior to execution, to use the same model (that could be provided by a third party such as Markit or one of the various competing providers)[18] or the same set of input data (including market data and scenarios) and calculation methodology (including models and software) for the calculation of their respective IM amounts.[19] Both approaches would result in IM amounts that are predictable for the counterparties, significantly reduce the potential for disputes and improve the functioning of the global marketplace for collateral. Also, because such IM calculations would be based on independent third-party data, scenarios and methods, they would provide independence and transparency to both counterparties while avoiding over-reliance on internal models and input data of the firms. We note that both the Federal Housing Finance Agency ("***FHFA***") and the Farm Credit Administration ("***FCA***") have considered explicitly permitting their regulated entities to delegate the IM calculation to independent third parties[20] and we urge the Commission to also embrace this approach.

We believe that the use of an agreed upon third party as calculation agent or as provider of inputs and calculation methodologies for IM between certain counterparties will be most appropriate for the more standardized, uncleared security-based swaps.[21] In contrast, counterparties might not want to rely on the use of a third party to determine their IM amounts for the more complex and less actively-traded products. To provide counterparties with the necessary flexibility to establish efficient means of IM calculation, the Commission should therefore explicitly allow counterparties to: (a) agree that their respective IM amounts for transactions between them will be either calculated by a third party provider agreed to by the counterparties or be based on inputs, scenarios, models and methodology provided by such a third party

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[16] BCBS IOSCO proposes that "risk-sensitive quantitative models . . . could be used to establish haircuts so long as the model is approved by supervisors and is subject to appropriate internal governance standards." *See* BCBS IOSCO Consultative Paper at 16.

[17] BCBS IOSCO Consultative Paper at 14 ("Moreover, parties may agree to use a single model for the purposes of such margin model calculations subject to bilateral agreement and appropriate regulatory approval.").

[18] Such third parties, that will be independent of the counterparties, would each use one set of market data, scenarios, analytics, and software to serve as the "IM calculation agent" for transactions between these counterparties.

[19] Our experience has shown that the individual situation and preferences of the parties determine their preference for a "hosted" (where the actual calculation is performed by the third party) or a "deployed" solution (where the third party only provides "standardized" inputs, analytics and software to the counterparties that will perform the actual IM calculation themselves). Market practice today allows for banks to get approval for capital models provided by a third party and some approvals have been given to different banks that use the same model. We therefore believe that regulatory authorities should not only approve third-party IM models that are used internally, like for capital model purposes, but also extend approval to third-party IM models that are hosted by the third-party.

[20] *See* Prudential Regulators Proposal Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. at 27595, 27596.

[21] We note that, similarly, CCPs routinely deliver scenario files to their clearing members on a daily basis to enable them to reproduce their IM calculations.

provider; and (b) apply such approach to specific products or categories of products in an asset class while choosing to use a model-based IM calculation by the individual firms or a grid-based approach for others.

3. Parties Should Be Permitted to Choose Between Model-based and Grid-based IM Calculation on a Sufficiently Granular Basis

BCBS IOSCO's Consultative Document permits counterparties to choose between the use of a model-based and a grid-based approach for their IM calculation, but does not allow parties to "switch between model- and schedule-based margin calculations in an effort to 'cherry pick' the most favorable IM terms."[22] It states that this choice should be made on a "consistent basis over time" and "for all transactions within the same well-defined asset class."[23] The Commission's Proposed Rule seems to provide parties with flexibility when they decide whether to use a model- or a grid-based IM calculation.[24] We urge the Commission to maintain this flexibility, which would be consistent with the clarification by BCBS IOSCO,[25] for the reasons below.

Given the multitude of financial products that can fall into an "asset class," their varying degrees of complexity, and limits to modeling abilities, we believe that there will always be challenges to fit certain products in an asset class into a model-based IM calculation. The BCBS IOSCO approach might therefore result in entire asset classes not being eligible for a model-based approach which, we believe, would unnecessarily restrict its use. To allow a larger number of buy-side and sell-side counterparties to make use of model-based calculations with all of the benefits described in more detail above, they should be permitted to make this choice not only by overall asset class, but also by product category within an asset classes. Alternatively, counterparties should at least be able to make use of an exemption within the asset class.

We believe that this would better reflect market realities while enabling an overall increased use of model-based IM calculation, thereby reducing the overall cost of the IM requirement. Such approach would also allow the Commission to require the use of more conservative grid-based models for those products that, in their opinion, cannot be reliably modeled.

Further, market participants may wish to use different IM models for different categories of swaps, and we believe they should be permitted to do so. For example, market participants may find that a third-party-provided IM model accurately reflects the risk for their standardized swaps, but may wish to use an internal, proprietary model or a grid-based approach for more complex and bespoke swaps. We therefore believe that the Commission should grant counterparties the flexibility to choose between these approaches so long as it is consistently applied to swaps within the same category of swap.

4. The Commission Should Clarify the Frequency with which IM Calculation and Collection are Required

The BCBS IOSCO Consultative Document states that "the amount of IM . . . can change over time, particularly where it is calculated on a portfolio basis and transactions are added to or removed from the portfolio on a continuous basis."[26] It further clarifies that counterparties are expected to collect IM "at the outset of a transaction" and "thereafter on a routine and consistent basis upon changes in potential future

[22] *See* BCBS IOSCO Consultative Paper at 13.
[23] *Id.*
[24] The Commission's proposal generally allows firms a choice between a model-based and standardized approach for IM calculation.
[25] BCBS IOSCO Consultative Paper at 13 ("At the same time, it is quite possible that a market participant may use a model-based initial margin calculation for one class of derivatives in which it commonly deals and a scheduled-based initial margin in the case of some derivatives that are less routinely employed in its trading activities.").
[26] *See* BCBS IOSCO Consultative Paper at 10.

exposure, such as when trades are added to or subtracted from the portfolio."[27] In contrast, the proposed IM requirements from the Prudential Regulators states that "Covered Swap Entities" must review, and, "as necessary", revise the data used to calibrate the initial margin model "at least monthly" and "more frequently as market conditions warrant."[28] We support the SEC's proposal that IM calculations must be performed daily at the close of business and that an increased frequency (*i.e.* intra-day) may be required during periods of extreme volatility and for accounts with concentrated positions.

We agree that the addition or removal of security-based swap transactions to a portfolio of existing transactions will lead to changes in the overall IM amount. However, the overall IM amount for the portfolio can also change even if no transactions are added or removed if, for example, existing transactions mature or significant market moves occur. We therefore encourage the Commission to clarify how often portfolio IM needs to be collected by the counterparties. This would clarify the circumstances under which IM re-calculations for an existing portfolio of transactions have to be performed even if no changes have been made to the trade population. Further, it would clarify when a change in calculated IM for the portfolio would require the counterparties to actually collect additional IM (or pay back excess IM). While regular re-calculations of portfolio IM might be appropriate even if the trade population has not changed, we believe that the Commission should allow for a minimum transfer amount for the actual IM payments as it proposed[29] to avoid creating unnecessary operational burden.

5. Counterparties Should be Permitted to Reference Third Parties for Dispute Resolution, Valuations, or Inputs in Relation to their VM Calculations

BCBS IOSCO proposed that counterparties must establish dispute resolution procedures to achieve agreement on valuations of their uncleared swaps as a basis for the collection of VM.[30] We agree that the existence of such dispute resolution procedures would be useful to ensure the timely agreement and collection of VM. To ensure they can be achieved in a cost effective and timely manner, we believe that counterparties should be explicitly allowed to reference valuations or arbitration procedures performed by independent third parties. Third party procedures would be useful in this context because third parties: (i) do not have any positions and therefore do not have any inherently subjective financial interest in the prices they calculate; (ii) use multiple data sources which helps to remove management bias; and (iii) offer both parties in the dispute substantial transparency into the valuation inputs, methods and procedures so the parties can more effectively debate and resolve the dispute.[31]

We note that the CFTC established requirements for counterparties to agree on a process which could contain methodology, inputs and fallbacks for the valuation of their uncleared security-based swap transactions that would be used as basis for the exchange of VM, and permits counterparties to agree to reference these elements or the actual valuation as they are provided by a qualified third party.[32] We recommend that the SEC follow the example of other regulators and explicitly allow counterparties to reference third parties for dispute resolution, valuation or inputs in relation to the calculation of VM.

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Markit appreciates the opportunity to comment on the SEC's Proposed Rule: *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants*

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[27] *See id.* at 13.
[28] Prudential Regulators Proposal Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. at 27591.
[29] *See* Proposed Rule, 77 Fed. Reg. at 70272 (based on the proposals of the Prudential Regulators and the CFTC).
[30] *See* BCBS IOSCO Consultative Paper at 14.
[31] It should be noted that both the buy- and sell-side are actively discussing third-party valuation agents and their potential role in standardizing the calculations for bilateral margining.
[32] *See* Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 77 Fed. Reg. 55904 (Sept. 11, 2012).

for Capital Requirements for Broker-Dealers. 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

cc: Peter Y. Malyshev, Latham & Watkins LLP