

13 June 2013

Mr. Tim Pinkowski
General Secretariat
International Organization of Securities Commissions (IOSCO)
Calle Oquendo 12
28006 Madrid
Spain

Submitted to RetailStructuredProducts@IOSCO.org

Re: **Regulation of Retail Structured Products**

Dear Sir/Madam:

Markit¹ is pleased to submit the following comments to the International Organization of Securities Commissions ("**IOSCO**") in response to its Consultation Report on *Regulation of Retail Structured Products* (the "**Consultation Report**" or the "**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. As part of our services we provide clients with valuations for a variety of financial products. Specifically, our Markit Portfolio Valuations business provides over three million post-trade valuations for OTC derivatives, securities, and structured products in any given month to the buy-side community. Our clients use these valuations primarily for independent price verification and financial reporting.

Markit has been actively and constructively engaged in the discussion regarding regulatory reform of the financial markets. We regularly provide regulatory authorities with our insights on current market practice, for example in relation to valuation methodologies, the provision of scenario analysis, and the use of reliable and secure means to provide daily marks. We have also advised regulatory bodies on potential approaches to enable the timely and cost-effective implementation of newly 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. Over the last several years, we have submitted over 80 comment letters³ to regulatory authorities around the world and participated in numerous roundtables.

Responses to IOSCO's specific issues

Issue 1 for consultation: Do you think the survey results accurately reflect the regulation and markets of the respondent jurisdictions? Are there any other relevant facts, regulations or dynamics that the Working Group should consider?

On the basis of our own research in relation to retail structured products,⁴ we agree with most of IOSCO's survey results.⁵ Specifically, we believe that a move towards simpler product structures is underway, with

¹ Markit is a financial information services company with over 3,000 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 Consultation Report: Regulation of Retail Structured Products. April 2013.

³ This number includes responses submitted by MarkitSERV, a now wholly-owned subsidiary of Markit Group.

⁴ Markit's Portfolio Valuations group conducted market research on the retail structured product industry in September 2012.

the bulk of the volume for newly launched Structured Products concentrated on a small number of fundamental payoff types. We have also found that issuer risk is often a key driver of fair value and that various regulatory bodies now require increased transparency to be provided to end investors of these products. Finally, our discussions with various issuers and service providers have led us to conclude that investors are increasingly interested in receiving independent price verification of retail structured products.

However, statistics from an online database of structured products⁶ seem to show that the overall retail structured product market has been growing steadily for the last five years. This seems to contrast with IOSCO's survey comments that the retail structured product market "suffered a contraction due to the recent financial crisis, with some modest recovery since then."⁷

Issue 5 for consultation: Could the use of modelling as contemplated by this regulatory tool have an impact on the production of better value products and products that perform as intended or better disclosure? What are the risks with using modelling as contemplated by this regulatory tool? Do you think investors would benefit from having access to the results of the modelling? Could IOSCO members require issuers to provide other information on the potential performance of the product?

Currently the term sheets of many retail structured products already incorporate some basic scenario analysis of potential returns. However, we believe that it would be helpful for investors if such scenarios were standardised, to the extent possible, providing a clear and comprehensive view of product risks. This standardisation would also allow for easier comparison between different product offerings.

Additionally, we believe that IOSCO should consider the FSA's finalised guidance on Retail Product Development and Governance – Structured Product Review which suggests that stress tests could be carried out independently of the product design team.⁸ By allowing, or potentially even requiring, third-party scenario and price verification, IOSCO's approach would be consistent with existing regulations⁹ and best practices¹⁰ for OTC derivatives and illiquid securities in some jurisdictions. At the very least, we believe that IOSCO should consider requiring an independent review of the assumptions underpinning the modelling to ensure that they are appropriate and consistent with market practice. We believe that adding these elements would contribute to the transparency of valuations and benefit end investors in Structured Products.

Issue 8 for consultation: How prescriptive is it appropriate for IOSCO members to be in setting issuer disclosure standards? What topics or items could benefit from specific explanation requirements? Do you think that risk indicators or minimum information requirements are useful? If so, what should the indicators or requirements be? How else could disclosure to investors on retail structured products be improved? Is there any disclosure that should be prescribed or proscribed?

Issue 9 for consultation: Do you think it appropriate that IOSCO members mandate or encourage short-form or summary disclosure? Would such disclosure be helpful to investors in understanding the products that they are purchasing? What are the risks associated with such disclosure? At what point in time should investors be provided access to this disclosure and what responsibility should the issuer have with respect to the content of the disclosure? What information do you believe IOSCO members could require to be included in a short-form or summary disclosure? If IOSCO

⁵ IOSCO CR "Observations from Round Table Attendees," page 32.

⁶ See www.structuredretailproducts.com.

⁷ IOSCO CR "Observations from Round Table Attendees," page 32.

⁸ See <http://www.fsa.gov.uk/static/pubs/guidance/fg12-09.pdf>, section 9.1.

⁹ For example, in Luxembourg, CSSF Circular 11/512 and Circular 08/380 call for an implementation of a "process for accurate and independent assessment of the value of OTC derivatives" and indicate that UCITS must be able to determine the "appropriate, transparent and fair valuation of OTC value". Forthcoming regulation implementing the Alternative Investment Fund Managers Directive ("AIFMD") will require non-UCITs structures to have proper and independent asset valuation processes in place, which could be performed either internally or by an external party.

¹⁰ For example, AIMS's Guide to Sound Practices for Hedge Fund Valuation recommends that conflicts of interest in the valuation process are usually best managed by the appointment of an independent and competent Valuation Service Provider.

members require the use a short form or summary disclosure, should this disclosure allow comparisons across products and, if so, what products should be able to be compared?

Issue 12 for consultation: Do you think it appropriate that IOSCO members prescribe disclosure of scenarios? If so, what should these scenarios be? Do you consider there to be an alternative/simpler method of disclosing scenarios to retail investors?

Issue 13 for consultation: Do you think that disclosure of backtesting is useful to investors? What are the risks associated with such disclosure? Is there any other way to use backtesting to help retail investors?

We believe that the risks of Structured Products should be presented in a clear, concise and consistent manner and comparability between products should be ensured. We therefore believe that a more prescriptive approach on at least the short-form/summary disclosure might be helpful to end investors.

The various disclosures that have been proposed by IOSCO¹¹ would be useful from a valuation/pricing and risk perspective. However, we believe that a greater level of detail would be needed to ensure consistency and broader use of Scenario Analysis and Risk Indicators. For example, standardising the market events that should be used as inputs for the generation of historical scenarios and suggesting a set of standard forward-looking scenarios would provide investors with greater comparability across products. Given that not all products will be exposed to the same risks, specific scenarios should be required for some products/payout profiles to illustrate any non-standard risk exposures.

Issue 11 for consultation: Do you think disclosing the estimated fair value of a structured product at the time of issuance will be helpful to investors?

We believe that investors would benefit from issuers of structured products disclosing the estimated fair value at the time of their issuance, particularly if such fair value was calculated in a consistent, transparent, and comparable manner by issuers (or third-parties) across similar products.

Such approach would also seem consistent with CFTC requirements for OTC derivatives where Swap Dealers are required to provide a pre-trade mid-market mark to counterparties at or before the time of execution, in order to allow their (end investor) counterparties to assess the true cost and mark-up of the product and compare it with the relative fair value of other products.¹² Further, it is worth noting that the SEC has been working to improve disclosures about structured notes including requiring information regarding their pricing.¹³

Issue 16 for consultation: What other areas of activity could IOSCO members consider in the post sales period? Please explain. Are there issuers, that are not distributors, that make a secondary market in retail structured products (i.e., would the regulatory tool on secondary market making ever be relevant)?

We believe that it would benefit Structured Products investors if post-execution independent price verification was required for retail structured products, particularly where there is no active secondary market for the product.

This would follow existing valuation standards and best practices currently in use for the OTC derivatives market, e.g. CFTC requirements for Swap Dealers to provide their counterparties with a daily post-trade

¹¹ IOSCO CR "Short-form or summary disclosure," page 47.

¹² Business Conduct Standards for Swaps Dealers and Major Swap Participants with Counterparties. 77 Fed. Reg. 9734. (February 17, 2012).

¹³ The SEC sent letters to JPMorgan Chase & Co, Bank of America Corp, Citigroup Inc., Goldman Sachs Group Inc and Morgan Stanley on 12 April 2012, with 14 comments about their marketing, pricing and distribution practices for structured notes that these banks issued from April 2009 through March 2012.

mid-market marks for non-cleared OTC derivatives.¹⁴ It would also be in line with proposed CFTC requirements in relation to daily collection of variation margin where the calculation method would have to be agreed by both counterparties before entering into the transaction.¹⁵

We believe that post-trade valuations of retail structured products would benefit from consistent and transparent independent price verification. Such valuations would assist in the dispute resolution process by eliminating any potential bias from the calculation of the fair value of the product that might exist if such valuation was calculated by the provider of the product.

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Markit appreciates the opportunity to comment on IOSCO's Consultation Report on *Regulation of Retail Structured Products*. 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

¹⁴ Business Conduct Standards for Swaps Dealers and Major Swap Participants with Counterparties. 77 Fed. Reg. 9734. (February 17, 2012).

¹⁵ Margin requirements for non-centrally cleared derivatives. February 2013.