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August 11, 2015

**By Electronic Mail**

*Re: Investment Company Reporting Modernization, Proposed Rule, 80 Fed. Reg. 33,590  
(June 12, 2015)*

Secretary  
Securities and Exchange Commission  
100 F Street NE.  
Washington, DC 20549–1090

Dear Sirs and Mesdames,

Markit appreciates the opportunity to comment on the Securities and Exchange Commission (“SEC” or “Commission”) Investment Company Reporting Modernization proposal (the “Proposal”). Markit (NASDAQ: MRKT)<sup>1</sup> is a global financial information services company, offering independent data, valuations, risk analytics, trade processing, and related services across regions, asset classes and financial instruments.<sup>2</sup> Markit is an independent index Administrator for over 14,000 indices, many of which are utilized as reference for exchange-traded products or to benchmark the performance of registered investment company funds. Markit, on a voluntary basis, administers its relevant indices in accordance with the International Organization of Securities Commissions (IOSCO) Principles for Financial Benchmarks.<sup>3</sup>

Markit has been actively and constructively engaged in the debate about regulatory reform in financial markets, including topics such as the implementation of the Pittsburgh G20 commitments for OTC derivatives and the design of a new regulatory regime for benchmarks and indices. Over the past years, we have submitted more than 120 comment letters to regulatory authorities around the world and have participated in numerous roundtables.

In general, we support the Proposal’s goals to (i) increase the transparency of fund portfolios and investment practices, (ii) take advantage of technological advances, while (iii) avoiding duplicative or otherwise unnecessary reporting burdens on the industry. It is in the spirit of these goals that we offer these comments. We believe the Commission can achieve these goals with minimum adverse effect, if, in general, it errs on the side of disclosure and transparency rather than prescriptive requirements.

**I. Executive summary**

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<sup>1</sup> Please see [www.markit.com](http://www.markit.com) for further information.

<sup>2</sup> As of year-end 2013, 37% of Markit’s customers were buy-side customers, 12% corporate and insurance end-user customers, 20% bank customers, and 5% were government or academic. Approximately 50% of Markit’s revenues in 2013 originated in the U.S.

<sup>3</sup> IOSCO, Principles for Financial Benchmarks, July 2013, <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf> (IOSCO Principles). See also IOSCO Compliance Disclosure, Markit administers its benchmark products in compliance with the IOSCO Principles, Dec. 3, 2014, [http://www.markit.com/Content/Documents/Products/Disclosures/IOSCO\\_Compliance\\_disclosure.pdf](http://www.markit.com/Content/Documents/Products/Disclosures/IOSCO_Compliance_disclosure.pdf).

Our comments focus on two topics touched upon in the Proposal that directly relate to core services we provide: (1) indices and (2) valuation.

With respect to indices, we support policies that would encourage reference instrument indices be administered in accordance with the IOSCO Principles for Financial Benchmarks<sup>4</sup> through, for example, the disclosure in the Form N-PORT of an indicator for indices used in reference instruments that indicates whether the index is certified to be compliant with the IOSCO Principles or not. Such an indicator would provide the Commission, investors, and the public some assurance that the underlying index has a transparent methodology and processes in place to ensure the integrity of the benchmark, its representativeness for the market it measures, and that index Administrator has identified and appropriately addressed conflicts of interest. This disclosure would incentivize compliance with the IOSCO Principles and would, as a consequence, enhance transparency into the liquidity of the index's methodology and components, among other benefits.

With respect to disclosures relating to providing transparency over liquidity and valuation practices, in addition to disclosures relating to compliance with the IOSCO Principles for index products, Markit suggests the Commission consider disclosures indicating the uncertainty of valuation for thinly-traded securities. We also question the value of disclosing the name of third-party pricing or valuation service providers or consultants.

## **II. IOSCO Principles for Financial Benchmarks**

### **a. Markit would support policies that would encourage that reference instrument indices be administered in accordance with the IOSCO Principles**

We would support policies that would encourage (but not require) reference instrument indices to be administered in accordance with the IOSCO Principles for Financial Benchmarks.<sup>5</sup> The goals of the 19 IOSCO Principles are to, most importantly, “address conflicts of interest in the Benchmark-setting process,”<sup>6</sup> “enhance the reliability of Benchmarks,”<sup>7</sup> and ensure that there is sufficient transparency in the methodology used for the benchmark to allow stakeholders<sup>8</sup> “to

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<sup>4</sup> See IOSCO Principles.

<sup>5</sup> Id. The IOSCO Principles are intended to cover “Benchmarks,” a term that includes, but is not limited to, indices used in reference instruments. “Benchmarks” are defined by the IOSCO Principles as “prices, estimates, rates, indices or values that are: a) Made available to users, whether free of charge or for payment; b) Calculated periodically, entirely or partially by the application of a formula or another method of calculation to, or an assessment of, the value of one or more underlying Interests; c) Used for reference for purposes that include one or more of the following:

- determining the interest payable, or other sums due, under loan agreements or under other financial contracts or instruments;
- determining the price at which a financial instrument may be bought or sold or traded or redeemed, or the value of a financial instrument; and/or
- measuring the performance of a financial instrument.” Id. at 35.

<sup>6</sup> Id. at 3.

<sup>7</sup> Id. at 32.

<sup>8</sup> The IOSCO Principles define “Stakeholder” as “Subscribers and other persons or entities who own contracts or financial instruments that reference a Benchmark.” Id. at 37.

understand how the Benchmark is derived and to assess its representativeness, its relevance to particular Stakeholders, and its appropriateness as a reference for financial instruments.”<sup>9</sup>

The IOSCO Principles’ goals are consistent with the purposes of the Investment Company Act of 1940 (Investment Company Act).<sup>10</sup> For example, the Investment Company Act seeks to promote transparency in order to enable investors to have access to “accurate, and explicit information, fairly presented, concerning the character of such securities.”<sup>11</sup> The prevention of conflicts of interest is also at the core of both the IOSCO Principles and the Investment Company Act.<sup>12</sup> In essence, the IOSCO Principles ensure that the same common-sense regulatory principles at the core of securities law extend into the relatively new world of financial indices.

IOSCO, when publishing the IOSCO Principles, explicitly encouraged IOSCO members, including the Commission, to implement the Principles through regulatory action, where appropriate.<sup>13</sup> We encourage the Commission to utilize the IOSCO Principles as a resource as they consider finalizing the Proposal and in any other policy matter involving indices.

The IOSCO Principles also called for Benchmark Administrators to publicly declare the extent of their compliance. As of December 2014, all Markit Benchmarks are administered in accordance with the IOSCO Principles.<sup>14</sup> The process required to come into compliance with the IOSCO Principles was costly, but in our opinion justified to secure and further enhance the integrity of our benchmarks.

**b. The Commission could address proprietary non-public index providers’ concerns about the disclosure of non-public index components by providing an exemption conditioned on the index providers certification that the index is administered in a manner consistent with the IOSCO Principles**

The Proposal asks whether disclosing on a quarterly basis the components of a proprietary non-public index may include costs to the index provider, whose proprietary indexing strategy could be reverse engineered.<sup>15</sup> Markit does not at this time have an opinion regarding this question.

Nevertheless, we do have a suggestion of how the Commission could continue to encourage transparency in the event it decides to exempt non-public indexes from the component disclosure requirement. If the Commission were to create such an exemption, we would suggest that it apply only if the non-public index is administered in accordance with the IOSCO Principles. This would ensure that, at the minimum, for such non-disclosed component indices that the Commission, investors, and the public would have some degree of visibility into the methodology<sup>16</sup> and data inputs,<sup>17</sup> among other things, used by the index, as set forth by the IOSCO Principles.

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<sup>9</sup> Id. at 12.

<sup>10</sup> See Investment Company Act, section 1(b).

<sup>11</sup> Id. at section 1(b)(1).

<sup>12</sup> See id. sections 1(b)(i) and (3).

<sup>13</sup> IOSCO Principles at 7.

<sup>14</sup> See supra at note 3.

<sup>15</sup> See Proposal, 80 Fed. Reg. at 33,663-33,664.

<sup>16</sup> See e.g., IOSCO Principles at 21-22 (IOSCO Principle 9 (“Transparency of Benchmark Determinations”) suggests benchmark Administrators provide a “concise explanation, sufficient to facilitate a Stakeholder’s or Market Authority’s ability to understand how the determination was developed, including, at a minimum, the size and liquidity of the market

Under the IOSCO Principles, such a non-public index provider (or “Administrator”<sup>18</sup> under the IOSCO Principles) should provide transparency into the methodology and data used by the Administrator to “allow Stakeholders to understand how the Benchmark is derived and to assess its representativeness” under IOSCO Principles 9 (“Transparency of Benchmark Determination”) and 11 (“Content of the Methodology”),<sup>19</sup> to the extent appropriate given the proprietary nature of its index under the IOSCO Principles’ concept of proportionality. The IOSCO Principles’ concept of proportionality provides that “the application and implementation of the Principles,” for example those relating to transparency of data and methodology, “should be proportional to the size and risks posed by each Benchmark and/or Administrator and the Benchmark-setting process.”<sup>20</sup>

### III. Liquidity and valuation-related disclosures

The Proposal would enhance the ability of the Commission, investors, and the public to assess the liquidity characteristics of the investments in a fund portfolio by, most importantly, the provision of (i) an indicator identifying which assets were fair valued using “significant unobservable” inputs,<sup>21</sup> (ii) an indicator for “illiquid assets,”<sup>22</sup> and (iii) an indicator stating whether an asset was valued using Level 1, Level 2, or Level 3 inputs for its fair valuation, as these levels are defined under U.S. Generally Accepted Accounting Principles.<sup>23</sup> The Proposal asks further:

“Are there additional items that should be included on Form N–PORT in order to improve the transparency regarding the liquidity and valuation of investments? For example, should the Commission require additional disclosure regarding the fund’s valuation of its investments, such as the primary pricing source used (e.g., exchange, broker quote, third-party pricing service, internal fair value), the name of any third-party pricing source, or whether an independent consultant or appraiser assisted with development of internal fair value? If so, should such information be disclosed on an individual security basis? Would such information increase the transparency of the pricing of thinly traded securities?”

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being assessed (meaning the number and volume of transactions submitted). See also discussion *infra* below regarding transparency standards under the IOSCO Principles.

<sup>17</sup> *Id.* at 21.

<sup>18</sup> *Id.* at 35 (“Administrator: An organisation or legal person that controls the creation and operation of the Benchmark Administration process, whether or not it owns the intellectual property relating to the Benchmark. In particular, it has responsibility for all stages of the Benchmark Administration process, including: a) The calculation of the Benchmark; b) Determining and applying the Benchmark Methodology; and c) Disseminating the Benchmark.”).

<sup>19</sup> See *id.* at 22-23 (IOSCO Principle 11 suggests, for example, index Administrators “disclose to all relevant stakeholders sufficient information to allow them “to understand how the Benchmark is derived and to assess its representativeness.”).<sup>19</sup>

<sup>20</sup> *Id.* at 5.

<sup>21</sup> Proposed Rule 12-13, described in Proposal, 80 Fed. Reg. at 33,618. The Proposal expects that “funds ... identify each investment categorized in Level 3 of the fair value hierarchy in accordance with ASC Topic 820” with this indicator. *Id.* at 33,623.

<sup>22</sup> Form N–PORT would, consistent with Commission regulatory precedent, define “illiquid asset” as “an asset that cannot be sold or disposed of by the Fund in the ordinary course of business within seven calendar days, at approximately the value ascribed to it by the Fund.” See proposed Form N–PORT, General Instruction E.

<sup>23</sup> See Proposal, 80 Fed. Reg. at 33,605.

Would investors benefit from such information and, if so, how? What costs and burdens would be associated with providing such information?”

Our comments below focus are intended to respond to questions contained in the quote above.

**a. The Commission could encourage adoption of the IOSCO Principles and the public benefits they promote through disclosure of an index’s status under the IOSCO Principles**

In response to the request for comment question asking “[a]re there additional items that should be included on Form N–PORT in order to improve the transparency regarding the liquidity and valuation of investments,”<sup>24</sup> we would suggest that for reference instruments using an index that there be a disclosure as to whether the index is administered in accordance with the IOSCO Principles. Such a disclosure would indicate to the Commission, investors, and the public whether the index is administered in a manner that ensures the integrity of the index through, among other things, requirements to identify and appropriately manage conflicts of interest and transparency of methodology. With respect to “transparency regarding the liquidity and valuation of investments,” the following IOSCO Principles are particularly relevant.

- IOSCO Principle 6 (“Benchmark Design”) suggests that benchmarks should take into account the liquidity of the underlying market in designing a benchmark and market concentration (the number of market participants active in the underlying market).<sup>25</sup>
- IOSCO Principle 8 (“Hierarchy of Inputs”) suggests that benchmark Administrators publish or make available clear guidelines “regarding the hierarchy of data inputs and exercise of Expert Judgment used for the determination of Benchmarks.”<sup>26</sup> The Principles recognize that “there might be circumstances (e.g., a low liquidity market) when a confirmed bid or offer might carry more meaning than an outlier transaction. Under these circumstances, non-transactional data such as bids and offers and extrapolations from prior transactions might predominate in a given Benchmark determination.”<sup>27</sup> In these instances, reliance on non-transactional data and judgment would be made public or made available to stakeholders.
- IOSCO Principle 9 (“Transparency of Benchmark Determinations”) suggests benchmark Administrators provide a “concise explanation, sufficient to facilitate a Stakeholder’s or Market Authority’s ability to understand how the determination was developed, including, at a minimum, the size and liquidity of the market being assessed (meaning the number and volume of transactions submitted).”<sup>28</sup>
- IOSCO Principle 11 (“Content of the Methodology”) suggests Administrators publish or make available the methodology used to determine the index, including the “identification of potential limitations of a Benchmark, including its operation in illiquid or fragmented markets and the possible concentration of inputs.”<sup>29</sup>

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<sup>24</sup> Proposal, 80 Fed. Reg. at 33,606.

<sup>25</sup> IOSCO Principles at 20.

<sup>26</sup> Id. at 21.

<sup>27</sup> Id.

<sup>28</sup> Id. at 21-22.

<sup>29</sup> Id. at 22-23.

The IOSCO Principles ensure therefore that the Commission, investors, and the public would have transparency into, among other things, the liquidity of the components of the index, which can be closely related to the liquidity of fund's holdings. The disclosure of whether an index is IOSCO-compliant would encourage the use of transparent, IOSCO-compliant indices, enhancing therefore the availability of information regarding the liquidity of index components.

**b. For thinly-traded securities or investments in assets with thinly-traded underliers, the Commission should consider disclosures indicating the uncertainty of valuation**

The Commission requests comment on how it might “improve the transparency regarding the liquidity and valuation of investments” including “thinly traded securities.” Thinly-traded (or infrequently-traded) financial instruments could, but not necessarily, may be subject to considerable valuation uncertainty. Quoting the Bank of England's Rajeev Brar:

*If a bank has a position valued at 50 and the market is liquid such that the range of plausible valuations is known to be somewhere between 49.9 and 50.1 or if the position is complex and the market is illiquid such that the range of plausible valuations may be somewhere between 20 and 80, then the accounting representation of value is often largely the same. However from a risk and capital adequacy perspective it makes an enormous difference. Whereas accounting standards are looking at best estimates, the regulatory perspective is much more interested in downside risk.<sup>30</sup>*

While the Bank of England is concerned with the valuation of assets held by banks, similar significant valuation uncertainty may exist with managed fund investments, particularly when those assets are thinly-traded or based on thinly-traded underliers. The Commission may therefore want to consider whether it, investors, and the public would benefit from greater transparency into the degree of certainty associated with a disclosed fair value for certain categories of assets, e.g., thinly-traded securities or indices based on thinly-traded securities or derivatives. This could be done, for example, through a disclosure that would demonstrate the range of reasonable valuations for a thinly-traded asset.

Requirements defining how to describe valuation uncertainty are being established for European banks. Under these European prudent valuation requirements, the “prudent valuation adjustment” is the amount by which available capital would need to be adjusted if downside valuations (i.e. least favourable valuations) were used instead of the fair values from a firm's financial statements.<sup>31</sup> Information conveying the degree of valuation uncertainty would assist the Commission, investors, and public better assess the valuation and liquidity risks associated with a particular investment.

**c. Markit questions the value of disclosing the name of third-party pricing or valuation service providers or consultants**

With respect to the question relating to the disclosure of third-party service provider names, we question the benefit of the disclosure of third-party service provider name when, in fact, the

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<sup>30</sup> Prudence Defined, David Wigan, Q3 2013, Markit Magazine, <http://content.markitcdn.com/corporate/Company/Files/MagazineEntireIssue?CMSID=c6ed404b81824e4bad6bfd011ee8eea4>.

<sup>31</sup> See EBA FINAL draft Regulatory Technical Standards, Jan. 23, 2015, at Article 9, <https://www.eba.europa.eu/documents/10180/642449/EBA-RTS-2014-06+RTS+on+Prudent+Valuation.pdf>.

ultimate responsibility for fair valuation of portfolio assets lay with the board of the registered investment company and the use of a third-party service is no guarantee that the board deferred to the third-party service provider.<sup>32</sup> This disclosure, unless it includes a fulsome discussion of the fair valuation process the board used (which would likely be impractical), would expose third-party service providers to unwarranted reputational risk in the event a board misvalues an asset using the services of a third party (or multiple third parties). There are also practical challenges with complying with such a requirement when, as is often the case, a fund uses multiple vendors and the board uses discretion in using different vendors' services at different times.

The potential costs of this disclosure outweigh what little, if any, benefit would come from this disclosure. With some examples described above, there are other policy options that can provide the Commission, investors, and public more insight into pricing, valuation, and liquidity characteristics of portfolio assets.

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Markit appreciates the opportunity to comment on the Commission's Proposal. 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 Salman Banaei at [salman.banaei@markit.com](mailto:salman.banaei@markit.com).

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Schüler', with a stylized flourish extending to the right.

Marcus Schüler  
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<sup>32</sup> Investment Company Act, section 2(a)(41)(B).