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European Commission
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**Green Paper *Building a Capital Markets Union***

Dear Sirs,

We welcome the publication of the Green Paper *Building a Capital Markets Union* (the "***Green Paper***" or the "***GP"***) by the European Commission (the "***Commission***") and we appreciate the opportunity to provide you with our comments.

Markit[1] is a leading global diversified provider of financial information services. We provide products and services that enhance transparency, reduce risk and improve operational efficiency of financial market activities. Our customers include banks, hedge funds, asset managers, central banks, regulators, auditors, fund administrators and insurance companies. By setting common standards and facilitating market participants' compliance with various regulatory requirements, many of Markit's services help level the playing field between small and large firms and herewith foster a competitive marketplace.[2] Founded in 2003, we employ over 3,500 people in 10 countries. Markit shares are listed on Nasdaq under the symbol MRKT.

Markit has been actively and constructively engaged in the debate about regulatory reform in financial markets, including topics such as the implementation of the G20 commitments for OTC derivatives and the design of a regulatory regime for benchmarks. Over the past years, we have submitted more than 115 comment letters to regulatory authorities around the world and have participated in numerous roundtables. We also regularly provide 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 regulatory requirements, for example through the use of multi-layered phase-in or by providing market participants with a choice of means for satisfying regulatory requirements.

**Introduction**

We welcome the Commission's initiative on Building a Capital Markets Union ("***CMU***"). We believe that the Commission's stated objective of making the European financial markets work more effectively and efficiently[3] is highly laudable and, importantly, could prove to be a key ingredient in fostering growth and boosting employment in Europe.

[1] Please see www.markit.com for further details.
[2] For example, Markit's KYC Services provide a standardized end-to-end managed service that centralizes "Know Your Client" (KYC) data and process management.
[3] Section 1.1 of the GP

We strongly welcome the Commission's preference for market-led initiatives, rather than legislation, to deliver solutions in this context.[4] We believe that, in general, market participants are well positioned to provide input into formulating the policy objectives of the CMU and making European financial markets deeper and more resilient. Such approach will be particularly important at the current juncture following several years where regulatory authorities drove the agenda.

We agree that it is now appropriate for the Commission to focus on improving the effectiveness of the European financial markets. To achieve this objective the Commission should reassess recent regulatory changes, specifically those whose unintended consequences would inhibit the development of a CMU.[5] We also encourage the Commission to consider how the activities of firms, such as banks in their function as market makers, have been impacted by regulation and the consequences for market functioning. For example, there is evidence to suggest that banks are less likely to provide liquidity in secondary markets as a consequence of higher capital requirements.[6] Whilst we are not advocating the reversal of those changes, we encourage the Commission to consider how to mitigate their impact on liquidity. We share the Commission's view[7] that it will be crucial to understand how various sources of savings could be tapped more effectively as investments, and how asset managers, pension funds and insurance companies can perform an increasingly important role in providing market-based financing. That said we also encourage the Commission to consider new risks that such development could create and how those could best be quantified, monitored, and addressed.

We note that the primary focus of the Capital Markets Union is to promote market-based financing activity in Europe, and to ensure that sufficient funding is provided to sectors like SMEs. Whilst one objective will be to create the right conditions to enable primary issuance by businesses, we believe that this has to be complemented by a liquid secondary market for the trading of those instruments. This is because, while some investors might hold debt instruments to maturity, others will only invest if there is a secondary market. In its absence, there would be a reduced appetite for the primary issue and the cost of capital will be higher. This could then force businesses to continue their reliance on bank finance or restrict their ability to invest. We recommend the Commission focus on the following areas to promote secondary market liquidity: (i) secure an appropriate level of transparency in secondary markets; (ii) acknowledge the important role of indices and encourage continued innovation in this sector; and (iii) consider emerging risks of increased market-based financing.

**Comments**

**(i) Secure an appropriate level of transparency in secondary markets**

- ***Question 23) Are there mechanisms to improve the functioning and efficiency of markets not covered in this paper, particularly in the areas of equity and bond market functioning and liquidity?***

Transparency has been recognized as an important ingredient of properly functioning financial markets in a number of regulatory frameworks.[8] We note the Commission's view that, "despite the recent growth in corporate bond issuance", the European bond market is still "characterized by low levels of standardization and

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[4] "Legislation might not always be the appropriate policy response to these challenges, and the onus in many cases will be on the market to deliver solutions." See page 5 of the GP

[5] Specifically, we believe there might be value in the Commission fine tune some regulatory requirements where it could improve market functioning, reconsider some that might have proved overly onerous and perform a thorough assessment of their cumulative effects.

[6] See, for example, the ICMA "Survey Report -Liquidity in the European secondary bond market: perspectives from the market", November 2014. The report found that secondary market liquidity for European corporate bonds has suffered "mainly as a result of stricter capital requirements."
http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Secondary-Markets/survey-report-liquidity-in-the-european-secondary-bond-market-perspectives-from-the-market/

[7] Section 4.2 of the GP

[8] See Part 45 of Dodd Frank Act relating to Swap Transactions Reporting Requirements, as well as RTS 8 and RTS 9 MIFID ESMA CP relating to transparency requirements for equity and non-equity like instruments.

price transparency".[9] However, while additional transparency is welcomed, in the context of the CMU the Commission should carefully consider the potential negative impact that overly demanding transparency requirements can have on bond market liquidity.

Based on our experience in providing independent pricing and valuation services across many asset classes,[10] we believe that various forms of transparency play an essential role in ensuring the proper functioning of financial markets. However, any pre- and post-trade transparency that is required by regulations needs to be carefully calibrated in order to ensure that increased transparency does not come at the cost of reducing the much desired liquidity and contributes to the improvement of market functioning. That said, we believe that the relevance of transaction prices as pricing indicators in the non-equity markets generally tends to be overstated.[11] This is because they are typically not based on continuous trading. Also, these markets are characterized by a high degree of heterogeneity of products with, we believe, limited potential for further standardization.[12] Finally, additional information such as the transaction type and nature of the counterparties would be necessary to make transaction prices usable for transparency purposes. As a consequence, for financial products that trade over-the-counter and only on an occasional basis such as many fixed income instruments and derivatives,[13] a variety of sources of information other than transaction prices will often provide more accurate, timely and relevant indications of current pricing. The whole range of pricing sources, including transaction prices, will often be used as inputs into producing price indications by applying techniques such as "matrix pricing".[14]

With technical standards for MiFID 2 / MiFIR being finalized over the coming months, we believe that a thorough discussion about the appropriate calibration of post-trade transparency requirements in the European non-equity markets will be of specific relevance for the success of the CMU. There is a risk that requiring an excessive degree of post-trade transparency will create limited value whilst causing damage to secondary market liquidity. Specifically, liquidity providers are likely to retract from the market if they are forced to publish details of their transactions too quickly, making it difficult for them to hedge or reduce the position they acquired. In light of the objectives set in the GP, we urge the Commission to reassess the approach to applying equity-like transparency requirements to non-equity markets. Specifically, the calibration of any transparency regime must recognize that non-equity markets have much greater diversity and number of instruments, that such instruments are traded only on an infrequent basis, and often off exchange. The universe of truly "liquid" instruments in these markets is therefore small. We urge the Commission to ensure that this fact is reflected in any pre- and post-trade requirements. This could be achieved, for example, by allowing for sufficient delays in the public dissemination of trade information, the classification of a larger number of instruments as illiquid, a re-calibration of liquidity classifications and thresholds on a regular basis, and the allowance for sufficiently low SSTI and LIS thresholds.[15]

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[9] See page 15 of the GP

[10] Markit provides independent pricing services in the fixed income cash and derivatives markets, including corporate and sovereign bonds, asset backed securities, interest rate, FX and credit derivatives. We also recently launched a valuations service for illiquid debt and equity. Our services support price discovery, risk management, compliance, research and valuations.

[11] We use a variety of sources as inputs into our pricing services, including contributed pricing data from market makers' official books of record, market makers' quotes, CCPs' daily settlement prices as well as transaction prices, where available. Such data is processed using rigorous automated cleansing tests to ensure the quality of the resulting output. We promote the transparency of the prices that we produce by providing information about inputs, methodologies used and, for several services, also liquidity data.

[12] Ad *Question 6) Should measures be taken to promote greater liquidity in corporate bond markets, such as standardisation? If so, which measures are needed and can these be achieved by the market, or is regulatory action required?* - We note that the GP contains a discussion about the need for, and the potential benefits provided by, increased standardization of bond issuance. We believe that, whilst a certain degree of standardization of bond terms might be appropriate and useful in some circumstances, particular for larger and regular issuers, it is unlikely to work across the board. This is because bond issuance is often designed to satisfy the specific financing needs of businesses, including SMEs. We therefore believe that standardization of bond issuance should be allowed to progress in areas where it provides natural benefits, but see little benefit from taking any regulatory action in this respect.

[13] See BIS Derivative Statistics http://www.bis.org/statistics/derstats.htm

[14] Markit uses a combination of different kinds of information to create discount curves against which the specific instruments are then priced. The methodology, for example, would dictate interpolation techniques that could be employed for illiquid tenors and also algorithms to cleanse raw data. For less liquid asset classes such as European ABS we derive pricing inputs from the information available about the small universe of liquid assets in the universe. Pricing for these products will often involve also the use of expert judgment.

[15] RTS 9, MIFID ESMA CP.

**(ii) Acknowledge the important role of indices and encourage continued innovation in this sector**

- ***Question 5) What further measures could help to increase access to funding and channelling of funds to those who need them?***
- ***Question 19) What policy measures could increase retail investment? What else could be done to empower and protect EU citizens accessing capital markets?***
- ***Question 21) Are there additional actions in the field of financial services regulation that could be taken ensure that the EU is internationally competitive and an attractive place in which to invest?***
- ***Question 23) Are there mechanisms to improve the functioning and efficiency of markets not covered in this paper, particularly in the areas of equity and bond market functioning and liquidity?***

We note that the Commission does not specifically mention the role that indices and benchmarks play in supporting liquid and thriving financial markets. However, our experience as index provider, mainly in the fixed income markets,[16] has shown that indices can play an important role in improving the functioning of financial markets, namely by establishing an asset class as such, by broadening its accessibility and fostering its liquidity. This is because many market participants will only become aware of the existence of an asset class and its performance through the publication of an index. Further, institutional investors that the Commission would like to see invest[17] will typically be required by their clients to measure their performance against an index. The existence of an index will hence often be a precondition for active asset managers to access the asset class. Finally, the existence of an index enables the creation of derived financial products such as ETFs that provide access to the asset class for an even broader range of investors, including retail, in line with the stated objectives of the Commission.[18] The creation and publication of an index tends to increase liquidity of its individual constituents,[19] and it will ultimately allow for broader and cheaper financing for the entities that issue in this market segment. The Commission should note that these beneficial effects tend to be most pronounced in the less liquid market sectors, including those for medium-sized and smaller issuers.

The creation of fixed income indices plays an important role in connecting new types of investors with borrowers. This will also help alleviate some of the concerns about secondary market liquidity in CMU focus segments like SMEs and can encourage further primary market issuance in those sectors. In order for these benefits to accrue in the context of the CMU, we recommend the Commission carefully review several elements of its proposed Benchmark Regulation ***("BMR")***.[20] Specifically, the Commission should consider that excessive or overly demanding requirements of the BMR could discourage future innovation in the sector and even reduce the number of existing indices. This would also have an important impact on the competitiveness of the European financial markets[21] given that other major jurisdictions seem to have no intention of implementing comprehensive regulation of benchmarks.[22] The chilling effect on innovation in the index

[16] Markit is a global index provider and administrator for both cash and synthetic indices across fixed income and equities. For example, the Markit iBoxx European ABS index for performance measurement in the European ABS market. Markit also provides index-related services to enable customers to meet bespoke index requirements. Our customers for these services include banks, asset managers, hedge funds, insurance companies and corporate treasurers.
[17] See page 16 of the GP, "Boosting institutional investment".
[18] See page 9 of the GP, "Boosting the flow of institutional and retail investment into capital markets would promote the diversification of funding sources" and "Boosting retail investment", page 19 of the GP.
[19] The creation of a bond index can be seen as important tool to foster liquidity in its constituents. One relevant recent example is the creation of a bond index for the local SGD bond market. See http://www.bobsguide.com/guide/news/2013/Jun/19/markit-launches-iboxx-sgd-bond-indices.html
[20] " Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on indices used as benchmarks in financial instruments and financial contracts**"** http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:52013PC0641
[21] See Question 21 of the GP, "*Are there additional actions in the field of financial services regulation that could be taken ensure that the EU is internationally competitive and an attractive place in which to invest?"*
[22] See speech by CFTC Chairman Massad, http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-13: "That being said, we believe that direct government involvement in the administration of benchmarks, as has been proposed in the EU, would have adverse market consequences."

business is likely to be particularly pronounced in those asset classes that are less liquid or transparent today, i.e., the ones that are most important for the success of the CMU.

To allow for continued innovation in the area of indices and benchmarks, we recommend the Commission focus on achieving appropriate outcomes in relation to the following elements of the BMR:

- Given the large number and variety of indices and benchmarks,[23] it is crucially important that sufficient flexibility is provided to index administrators to allow them to take a proportionate approach to the implementation of the Regulation. This should be the case across the relevant requirements for non-critical benchmarks and their administrators,[24] including the Code of Conduct.[25]

- The Regulation defines a “benchmark” as an “index” that is used in a certain manner.[26] On this basis, any third party could unilaterally transform a published index level into a regulated benchmark, without a license or even consent provided by its administrator. To avoid indices and index administrators being drawn into scope of the Regulation by a third party against the will of the administrator, the Regulation should clarify that only those indices are captured as “benchmarks” under the regulation where the index administrator (a) has become aware of the use of this index as a benchmark and (b) has provided its consent to such use.

## (iii) Consider emerging risks of increased market-based financing

- **Question *23) Are there mechanisms to improve the functioning and efficiency of markets not covered in this paper, particularly in the areas of equity and bond market functioning and liquidity?***

The Commission highlights the key role that banks play in capital markets intermediation, but also mentions signs of “liquidity decreasing in some market segments”.[27] Indeed, over the last several years we have also observed a reduced willingness and/or ability of market making banks to hold positions in fixed income instruments.[28] We note that, with a reduced role of banks as market makers for bonds and increased volatility in the global fixed income markets, regulators have recently turned their attention to emerging risks in the asset management sector.[29] That said, we recommend the Commission also take these concerns into consideration in the context of the CMU to ensure it establishes a sound basis for the further growth of market-based financing in Europe.

Given the generally reduced liquidity in secondary markets and the increased relevance of non-banks holders of financial instruments, it will be important that such institutional investors present their clients with an accurate reflection of the value of their positions as well as their liquidity and risks. For example, while it is relatively straightforward to price an equity fund using “official” exchange transaction data, the nature of debt markets, including their heterogeneity and significantly lower levels of trading, makes it harder to do so. A more

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[23] “IIA members calculate over one million indices”. Please see IIA response on EC consultation on *“a Possible Framework for the Regulation of the Production and Use of Indices serving as Benchmarks in Financial and other Contracts”:* http://www.indexindustry.org/?page_id=1405

[24] We are supportive of the European Parliament’s approach to the BMR which adds proportionality across the requirements that are imposed on benchmark administrators.

[25] The implementation of a Code of Conduct for submitters has proved to be challenging for many Benchmark administrators and might sometimes question the viability of benchmarks. We therefore believe that the Regulation should not require it to be “legally binding” or “signed” for submitters to non-critical benchmarks. Instead, the benchmark administrator should be expected to make “reasonable efforts” to receive submissions only from submitters that comply with the Code of Conduct.

[26] See Section 1.5 of the EC consultation on *“a Possible Framework for the Regulation of the Production and Use of Indices serving as Benchmarks in Financial and other Contracts”.*

[27] See page 24 of the GP.

[28] Specifically, we have observed a drop in the number of risk holders for a range of fixed income instruments following the financial crisis. For example, post crisis the average number of market making risk holders in for investment grade bonds has fallen by around 35% with only a marginal recovery over the last several years.

[29] E.g., FSB Consultative document “Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions “

sophisticated approach to valuation can ensure that investors allocate their funds based on the right assumptions, which will reduce the potential for surprises and the risk of a "run" on a fund. As we have explained in previous responses,[30] measures that would help achieving these objectives are the use of valuations that are sufficiently independent and increased transparency around the risks of holdings:

- To reflect inherent conflicts of interest and prevent the risk of mismarking of positions,[31] it will be important to ensure that the valuations used by asset managers for their holdings of financial instruments are sufficiently independent. This has also been recognized in a number of regulatory frameworks.[32,33]

- Further, it would be useful for institutional investors to quantify and report on risks that are part of their portfolios of financial instruments. Such information would provide their investors with transparency about inherent risks whilst allowing regulators to monitor emerging systemic risks and take action where appropriate. Specifically, firms would quantify and provide transparency not just about the current value of their positions, but also about the second order risks of their holdings such as valuation uncertainty, concentration risks, and unwind costs.[34]. Such approach is already commonplace for European banks, for example through Prudent Valuation requirements and the Liquidity Coverage Ratio.[35]

We believe that measures such as these would help strengthen investor confidence in bond funds and result in improved consumer protection.

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We hope that our above comments are helpful to the Commission. We would be more than happy to elaborate or further discuss any of the points addressed above in more detail. In the event you may have any questions, please do not hesitate to contact us.

Yours sincerely,

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[30] Please see Markit Response on FSOC "*Notice Seeking Comment on Asset Management Products and Activities, 79 Fed. Reg. 77,488 (Dec. 24, 2014)":* https://www.markit.com/Company/RegulatoryResponsesFile?CMSID=3b57309372ca43228897fb3e35e171c5

[31] See, for example, a recent SEC Enforcement action on Credit Suisse that reflected internal conflicts of interest with respect to the valuation of subprime bonds: "Proper pricing would have reflected that Credit Suisse was incurring significant losses as the subprime market collapsed. The SEC alleges that the scheme reached its peak at the end of 2007, when the group recorded falsely overstated year-end prices for the subprime bonds". Available at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171485904

[32] For example, AIFMD pursues a relevant approach in this respect where "independent" valuations could be provided either by an internal function that is sufficiently independent of the position holders, or by an "External Valuer". Article 19 of the DIRECTIVE 2011/61/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010

[33] DIRECTIVE 2011/61/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010

[34] Section 3 "Core Approach for the determination of AVAs under article 105(14) of regulation (EU) 2013 (CRR)

[35] a) Draft RTS on Prudential Valuation under article 105(14) of Regulation (EU) 575/2013 (CRR) b) LCR as defined in Basel III (BCBS)