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London, December 18th 2015

Asset management market study - Terms of Reference

Dear Sirs,

Markit is pleased to submit the following comments to the FCA in response to its *Asset management market study - Terms of Reference* (the "***Terms of Reference***").

Markit[1] is a leading global diversified provider of financial information services.[2] Founded in 2003, we employ over 4,000 people in 11 countries and our shares are listed on Nasdaq (ticker: 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 130 comment letters to regulatory authorities around the world and have participated in numerous roundtables.

Introduction

Markit provides various services to asset managers across asset classes and throughout the trade workflow, helping them to conduct their activities effectively and efficiently. Importantly, many of our services are designed to facilitate compliance with regulatory requirements, herewith lowering barriers to entry and fostering competition in the market place. Examples of services we provide to the asset management industry that are relevant in the context of the FCA's upcoming Market Study are:

- Markit's Transaction Cost Analysis ("***TCA***") platform[3] provides asset managers (and sellside firms) with actionable insights to enhance and synchronise their trading-related execution quality management across asset classes. Asset managers use the service in their pre-trade analysis as well as in their order routing and optimal strategy selection. It also assists them in demonstrating best execution[4] to their clients after the transaction has been carried out.

[1] See www.markit.com for more details.
[2] 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 our services help level the playing field between small and large firms and foster a competitive marketplace.
[3] See https://www.markit.com/Product/Transaction-Cost-Analysis for more details.
[4] Best execution requirements for investment firms and asset managers for equities (MiFID I) and equities and non-equities (MiFID II)

- Markit's various pricing and valuation[5] services provide intra-day as well as end-of-day pricing information across asset classes including bonds, Credit Default Swaps ("***CDS***") and loans to asset managers, banks and corporates. The services apply rigorous cleaning algorithms to ensure high data quality and offer full transparency into the valuation methodology and inputs used. Markit further provides independent Liquidity Metrics[6] and liquidity scores for fixed income instruments which are based off our proprietary methodology that uses a range of pricing data, volume and trade count data as inputs.

- Markit's derivatives processing platforms are widely used by participants in the OTC derivatives markets today and are recognised as tools to increase operational efficiency, reduce cost, and secure legal certainty. The MarkitSERV[7] platforms facilitate the electronic confirmation of a large portion of OTC derivatives transactions worldwide, submit them for clearing to 16 CCPs globally, and, for many counterparties[8], report transaction details to trade repositories ("TRs") in Europe, the United States, Canada, Japan, Hong Kong, Singapore and Australia.

- Markit's kyc.com platform is widely recognised by financial market participants and corporates for providing standardised and repeatable processes designed to facilitate client onboarding. It helps subscribers to upload, disseminate and maintain over 200 types of documents across 45 categories, thus assisting firms ("subscribers") in performing due diligence on their customers ("contributors") to facilitate their compliance with KYC/AML requirements.

Based on our experience in providing our products and services to asset managers in the UK and elsewhere we provide below our comments in relation to the topics that the FCA raised in the Terms of Reference.

Comments

We believe that the FCA's Asset Management Market Study is timely given concerns amongst regulators and other stakeholders about increased systemic risk in the asset management sector[9] as well as doubts whether asset managers provide "value for money" to fund investors and whether competition in the sector is effective.

Based on our experience we believe that several improvements could help address such concerns. Specifically, we recommend the FCA consider requiring asset managers to: (a) provide sufficient transparency about the transaction costs they incur, complemented by definitions tailored to the needs of less sophisticated investors; (b) use effective and efficient solutions to comply with regulatory requirements and provide transparency to investors about it; (c) provide their investors with comprehensive transparency about the various risks of their investments; and (d) use benchmarks to measure their performance that are not subject to undue conflicts of interest and are administered consistent with the EU Regulation for Benchmarks.[10]

Please find below our more detailed comments about these four areas for improvement.

[5] See https://www.markit.com/Product/Pricing-Data for more details
[6] See https://www.markit.com/Product/File?CMSID=00bd57831a874fd1b1333717b563f77d for more details
[7] See http://www.markit.com/product/markitserv for more details
[8] Globally, we currently report transactions to Trade Repositories for over 100 firms and more than 1,000 entities, including most of the large, globally active dealers.
[9] The Financial Stability Board (FSB) launched a consultation in March to classify certain asset managers as systemically important (NBNI G-SIFI). See http://www.financialstabilityboard.org/2015/03/assessment-methodologies-for-identifying-non-bank-non-insurer-global-systemically-important-financial-institutions/ for more details
[10] Please see definition of "Performance Benchmarks" in the latest European council text ("I" item note) of EU Benchmark regulation: http://data.consilium.europa.eu/doc/document/ST-14985-2015-INIT/en/pdf

1. Management of and transparency about costs

The FCA stated that "an improvement in competition that reduced total charges paid by investors by a small amount could have a large impact on investors' net returns".[11] It also identified several issues that might inhibit fund investors' ability to "monitor costs and/or quality of services paid for using fund assets"[12] and voiced concerns that when fund investors are not able to observe such costs "asset managers' incentives to manage these costs effectively may be reduced".[13]

We agree with the FCA that improvements are possible in relation to both the amount of costs incurred by asset managers and the transparency about such costs to investors. Such measures are likely to reduce the overall level of costs and foster effective competition between asset managers on this variable.

a) Transparency about transaction costs and execution quality

The FCA observed that investors will often find it difficult to "isolate these (transaction costs) charges from the overall charge paid for the product and may not understand the impact of these charges on net future returns".[14]

We believe that asset managers can address this problem by providing appropriately tailored transparency about transaction costs to their investors. Importantly, such transparency should contain a level of detail that is appropriate to its audience since disclosure of excessive detail could be of limited value and might even result in creating confusion and misleading signals. Specifically, many investors will not be sophisticated enough to fully understand the meaning of sophisticated transparency metrics and the associated terminology. We therefore urge the FCA to ensure that asset managers, in addition to disclosing quantitative aggregate measures of transaction costs and execution quality, also provide their clients with adequate education and explanatory material on the relevant benchmarks and metrics used for transaction cost analysis (***"TCA"***).

Furthermore, we recommend the FCA consider whether investors would benefit from receiving a third-party evaluation of a fund manager's TCA practices. The use of a third-party evaluation to measure the effectiveness of a fund's trading practices could provide an independent, external review allowing its investors to assess a broad set of data and analytics as well as subject matter expertise. We believe that the value of a third-party service would be particularly pronounced for the review of implicit transaction costs. We suggest that such reviews would be made transparent to investors. The use of third parties for independent proof of a fund's best execution practices would become even more important in view of the upcoming MiFID II best execution requirements. With buy side firms being required to source data from all relevant execution venues[15] third parties[16] can help given their access to all relevant sources of data and their robust analytical frameworks to carry out this analysis for executing firms. The use of independent third parties in this context could also help present costs incurred by the fund manager being presented in a way that is easier for investors to understand and enable them to more easily compare different fund managers.

[11] See para. 2.3, Pg. 8
[12] See Pg. 29, 4.51
[13] See Pg. 29, 4.51
[14] See Pg. 29, 4.51
[15] Under MiFID II Best Execution requirements (see Article 27(10) (a),(b) of Directive 2014/65/EU) executing firms are required to take into account, inter alia, transaction data from trading venues, market makers, liquidity providers and systematic internalisers when demonstrating best execution to their clients.
[16] Markit's TCA platform sources transaction data for equities and fixed income instruments from a variety of venues and feeds it into its proprietary methodology to produce best execution metrics for its clients.

b) Reducing costs through use of efficient tools

The FCA stated that it would analyse how asset managers procure and pay for services that are employed for operating the fund.[17] It also indicated it would "check whether asset managers are willing and able to control costs and quality along the value chain."[18]

We note the FCA's focus on the costs of operating and managing funds by asset managers that are charged to their investors.[19] We agree that the elevated costs of operating an asset management business in compliance with regulatory requirements can act as barrier to entry to new providers. In light of this, we recommend the FCA focus on the cost effectiveness of fund management as a competitive factor[20] which could be achieved by an increased uptake of third party shared solutions.[21] Today, numerous third party service providers can help asset managers to operate their funds and comply with their regulatory obligations in an effective and efficient manner. Although, in principle, many of these activities could alternatively be conducted in-house, asset managers will typically from significant cost efficiencies when outsourcing their compliance operations to third parties,[22] while such approach will often also help firms to manage the conflicts of interest they are exposed to.[23] Reduced compliance costs for asset managers will translate into lower cost of investing and higher returns for fund investors. Specifically, our experience has shown that tasking qualified third parties[24] with the provision of such services[25] reduces the burden on asset managers, in addition to leveling the playing field and creating a competitive environment. We therefore recommend that the FCA encourage asset managers to increase their use of third party service providers to achieve this objective. Further, fund manager should provide increased transparency about their use of efficient tools to enable investors to better analyse "the impact of these charges on net future returns."

2. Improving transparency about risks and returns

For investors to make the right decisions about which funds to invest in, and for competition between asset managers to be effective, sufficient transparency needs to be provided about all of the risks inherent in the fund investments and appropriate benchmarks used to measure the performance of the fund.

a) Transparency about the various risk parameters of funds' investments

The FCA stated that "Improved transparency and disclosure can be important in driving more effective competition".[26]

We believe that the information that asset managers provide to their investors might often not be sufficient to fully inform them about a fund's risk / return profile. This can result in investors making suboptimal investment decisions and restrict the degree of competition between asset managers (given that variables they should compete on are not made sufficiently visible to their investors). Specifically we believe that to ensure sufficient

[17] See page 35.
[18] See page 29.
[19] For example, MiFID II requirements in relation to Best Execution and Payments for research are designed to minimize the costs for end investors.
[20] Best Execution requirements under MiFID I have resulted in increased compliance costs for fund managers.
[21] Shared solutions can be defined as solutions provided by independent third parties that act as a hub for all firms seeking to outsource their compliance requirements. It entails centralising the data provided by these firms which is then either processed and aggregated (e.g., pricing services based on contributions) or shared with other firms (e.g., Know Your Customer (KYC).
[22] For example, the Know Your Customer (KYC) obligations for firms entail collecting information from their clients that could be centralised and managed effectively using platforms such as the kyc.com services.
[23] Third parties provide independent valuation and market data for asset managers and also provide central shared solutions that assist in managing payments for research.
[24] Including providers of shared solutions such as trade confirmations or Know Your Customer (KYC) platforms.
[25] Such as pricing and valuations, CSA management (payments for research), or transaction cost analysis
[26] See para 2.5, Pg 9.

comparability between funds the FCA should encourage transparency of all relevant risks contained in asset managers' portfolios.

It is also worth noting that asset managers are increasingly performing bank-type financing functions via their investments in the fixed income markets[27] and are hence exposed to risks similar to those posed by banks. Banking regulators have already subjected banks to "prudent valuation" requirements which require banks to quantify risks from concentration, price uncertainty, early unwind, and model risks.[28] The FCA could address the risks arising in the asset management sector by expecting fund managers to comply with similar requirements.[29] We believe that investors in funds would benefit from being provided with prudent valuations on their holdings as it would increase transparency about risks such as market price uncertainty or concentration.

In the wake of an alarming reduction of liquidity in fixed income markets asset managers should also be transparent about the liquidity risks contained in their portfolios. Specifically, reduced liquidity and growing participation of asset managers in fixed income markets have created concerns whether asset managers' liquidity risk management capabilities are sufficiently robust to manage redemption requests in times of market stress. Recent examples have highlighted that this might often not be the case.[30] We believe that regulation recently proposed by the US Securities and Exchange Commission[31] in relation to liquidity risk management by asset managers could help address these challenges.[32]

b) Use of appropriate performance benchmarks

Analysis of the performance of active fund managers is a challenging task and will depend on the provision and use of an appropriate performance benchmark for the fund.

We believe that, for effective competition between asset managers to occur, it is imperative that the returns of funds are sufficiently comparable. As a general practice, asset managers will use indices to measure their performance against the market, with their outperformance against the market return often determining the fee payments to the fund manager. In this context it is crucially important that the indices that are used as performance benchmarks are sufficiently independent and not subject to conflicts of interest. We note that the recently finalized EU Benchmark Regulation sets a framework for the appropriate administration of indices that are used to measure the performance of an investment fund ("performance benchmarks").[33] We believe it is important that asset managers use either third party indices, or, where they want to administer indices themselves, they should do so in compliance with the EU Benchmark Regulation, including appropriate governance standards and management of inherent conflicts. This should apply whenever a fund manager produces a benchmark itself, uses additional input data or judgment when combining existing indices, or makes use of judgment in producing an index that is used to measure the performance of an investment fund.

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[27] See https://next.ft.com/content/1ba49682-1666-11e5-b07f-00144feabdc0

[28] The EBA has introduced Prudent Valuation requirements for banks under CRD IV. See https://www.eba.europa.eu/documents/10180/642449/EBA-RTS-2014-06+RTS+on+Prudent+Valuation.pdf

[29] Some of these risks, e.g. model risk, might be less relevant for asset managers.

[30] See reference to recent liquidations of bond funds, e.g., by Third Svenue (http://www.cnbc.com/2015/12/11/third-avenue-to-liquidate-junk-bond-fund-that-bet-big-on-illiquid-assets.html) and Lucidus (http://www.bloomberg.com/news/articles/2015-12-14/lucidus-has-liquidated-900-million-credit-funds-plans-to-shut)

[31] See SEC proposed regulation on Liquidity Risk management programs for Open-End funds: http://www.sec.gov/rules/proposed/2015/33-9922.pdf

[32] See http://www.sec.gov/rules/proposed/2015/33-9922.pdf

[33] See definition of "Performance Benchmarks" in the latest European council text ("I" item note) of the EU Benchmark regulation: http://data.consilium.europa.eu/doc/document/ST-14985-2015-INIT/en/pdf

We hope that our above comments are helpful to the FCA. 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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