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IOSCO Consultation Report: Post-Trade Transparency in the Credit Default Swaps Market

Dear Sirs,

We welcome the publication of IOSCO's Consultation Report *Post-Trade Transparency in the Credit Default Swaps Market* (the "***Consultation Report***" or the "***CR***") and we appreciate the opportunity to provide you with our comments.[1]

Markit is a leading global diversified provider of financial information services. We provide products that enhance transparency, reduce risk and improve operational efficiency. By setting common standards and reducing the cost of compliance with regulatory requirements, many of Markit's services help level the playing field between small and large firms and herewith foster a competitive marketplace.[2] Our customers include banks, hedge funds, asset managers, central banks, regulators, auditors, fund administrators and insurance companies. 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

Markit provides independent pricing for a variety of Credit Default Swaps ("***CDS***"), including CDS referencing single names, indices and tranches, to support price discovery, risk management, compliance, research and valuations in these markets. Our CDS pricing services use a variety of input sources, including contributed CDS data from market makers' official books of record, live quotes, CCPs' daily settlement prices as well as

[1] IOSCO Consultation Report "Post-Trade Transparency in the Credit Default Swaps Market." November 2014.
[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.

transaction prices, where available. All such data is processed using rigorous automated cleansing tests to ensure the quality of the resulting output. We promote transparency about the prices that we produce by providing information about pricing inputs and the methodologies used.

In addition to our commercial CDS pricing offering, we provide a free service[3] to further increase transparency and understanding in the marketplace for CDS more broadly. Specifically, Markit publishes, without charge, CDS settlement prices, index trade volumes as well as CDS-related news, commentary and education materials.[4] In total, Markit makes available CDS spreads for roughly 450 entities, including the constituents of the Markit CDS Indices, the largest financials and the G20 sovereigns.[5]

We support IOSCO's recommendation for increased post-trade transparency in the global corporate bond, structured finance and CDS markets[6] and we agree that it could help improving the accuracy of pricing and valuations for these instruments. Indeed, several of Markit's pricing services, for example our evaluated bond pricing product,[7] routinely use publicly reported transaction prices[8] as an input. This will be in addition to other categories of pricing inputs that are either aggregated to calculate composite levels or fed into a dynamic model, to provide independent pricing, transparency and liquidity data.

Comments

Please find below our comments on IOSCO's analysis of activity in the CDS markets and its recommendations in relation to post-trade transparency. Specifically, we believe that (a) regulatory authorities must be sufficiently diligent in their analysis of CDS data to ensure that any CDS transaction data that they use for the calibration of a post-trade transparency regime properly indeed reflects price forming flow, based on the removal of transactions that are non-price forming or that have been double counted; (b) any post-trade transparency regime for CDS must be carefully calibrated and include delays for less liquid instruments as well as for block trades to avoid damaging market liquidity; (c) the identities of counterparties to transactions need to be protected to secure their continued participation in the market; (d) to enable a timely and efficient implementation of any post-trade transparency regime the requirements should be phased in with implementation dates depending on the degree of standardization and the level of preparedness of the market participants that trade in the relevant instruments; and (e) whilst international coordination between regulators is needed, any specific post-trade transparency regime should also take into account the specificities of the markets in individual jurisdictions.

Question 1. Should IOSCO draw additional or alternate conclusions from the analysis of publicly available transaction-level post-trade data about CDS described in Part V of this report? Please explain and provide supporting evidence, including any additional data upon which these conclusions are based.

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[3] The service, called Markit Source, is accessible via www.markit.com.
[4] Markit Source CDS provides CDS settlement prices from Eurex, ICE, JSCC and LCH. Index trade volumes include daily volumes as well as monthly averages.
[5] Where the CDS contract is centrally cleared, the price provided is the CCP's settlement price. For CDS that are not centrally cleared, the price provided is the most recent CDS dealer quote for the 5 year maturity at the time of the report.
[6] CR, p. 16.
[7] Markit Pricing Data provides independent pricing, transparency and liquidity data on bonds across the universe of corporate and sovereign securities, municipal bonds as well as securitised products.
[8] For example transaction prices for bonds that are reported by "TRACE" in the United States. The Trade Reporting and Compliance Engine (TRACE) is the FINRA run mechanism that facilitates the mandatory reporting of over-the-counter secondary market transactions in eligible fixed income securities. See Trade Reporting and Compliance Engine, http://www.finra.org/Industry/Compliance/MarketTransparency/TRACE/index.htm. All broker/dealers who are FINRA member firms have an obligation to report transactions in corporate bonds to TRACE under an SEC approved set of rules. Id.

We appreciate IOSCO's efforts in analyzing available position and transaction data for various categories of CDS with the aim of measuring market activity for them.

We agree with IOSCO that gross notional, net notional and the total number of CDS contracts outstanding represent "some measure of market risk exposure".[9] However, we believe that only the traded notional of CDS should be used as measure of actual market activity and represent the most relevant input into the calibration of a post-trade transparency regime for this product. This is because the traded notional, assuming that any double counting or purely administrative activity have been removed, is representative of price forming flow.

We appreciate that IOSCO has tried to identify reasons for the significant drops in notional outstanding observed in the data, both on specific dates and over a period of time.[10] In our view, such drops in notional outstanding were most likely caused by factors such as backloading into clearing, compression runs, and by the expiry of contracts on the quarterly maturity dates.[11]

Question 2. Are the regulatory considerations evaluated in this report appropriate? Please explain and provide supporting evidence.

Our experience has shown that publicly available transaction prices can play a useful role as an input into valuations, but they cannot resolve all valuation challenges. This is particularly true for financial instruments that trade largely over-the-counter and infrequently. For example, given their low trade frequency, transaction prices are simply not available for the majority of instruments on any given day. Further, even if transactions have taken place on the day these transaction prices will generally not be current at the time of the valuation. Finally, reported transaction prices will often not be representative even of current market prices, for example because of special factors unknown to the user.[12] For such instruments, trade repository data would therefore be of limited worth in determining the actual value of a position.

We appreciate IOSCO's acknowledgment of the limitations that might exist in relation to the CDS data that is used.[13] Based on our experience in analysing CDS transaction data we strongly urge IOSCO and individual regulators to apply a sufficient degree of diligence and caution in this process. Firstly, particularly in the early stages of the implementation of a reporting regime, not all transactions might be reported accurately and without duplication. Secondly, even once reporting is performed properly, some of the reported data might not be relevant for the purpose of the analysis. Specifically, when gathering the relevant data to calibrate a post-trade transparency regime for CDS regulators will need to identify those transactions that are "price forming" or "at risk". Any failure to achieve this objective will result in the use of a volume and transaction count that overstates the actual liquidity of the relevant CDS market, sometimes significantly so. This could ultimately lead to the design of a post-trade transparency regime that imposes an overly demanding degree of transparency on the market with potentially harmful impact on market functioning and liquidity.

Specifically, we urge IOSCO and other relevant regulators to ensure that, for the purpose of their analysis, the following types of CDS transactions are not included in the count of overall transaction numbers and volumes:[14]

- Vendor-initiated terminations, e.g., multilateral compressions;
- Terminations triggered by bilateral compressions;
- Post-trade events resultant from a renaming or reorganization;

[9] CR, p. 14-15.
[10] Gross Notional Outstanding for iTraxx Contracts. CR, p. 21.
[11] Based on a review of the relevant transaction data from Markit's processing platform and public information provided by DTCC for the periods in question.
[12] E.g. package trades, option exercises, switches, etc.
[13] CR, p.13
[14] The majority of these transaction types will also be relevant for other asset classes.

- Transactions related to changes of internal trade identifiers;[15]
- Transactions with zero upfront fee, both new transactions and terminations;
- Intra-company trades;
- Backloading, e.g., where the original transaction was confirmed on paper;
- Amendments; and
- Allocations

Further, there are likely to be situations where transactions are double counted on a systematic basis. To identify price forming flow additional work will often be required to eliminate double counting that might have occurred, in particular in relation to the following transaction types:

- Centrally cleared transactions;
- Assignments; and
- Prime brokerage trades.

If not properly accounted for, the inclusion of the above transaction types will lead to an *overstatement* of both volumes and transaction count.[16] We strongly encourage IOSCO and individual regulatory authorities to actively work with the industry and the relevant infrastructure providers to ensure that the data they plan to use for the calibration of post-trade transparency regimes for CDS is reflective of the "price forming flow". Any failure to achieve this objective is likely to result in transparency regimes that are overly aggressive and potentially harmful to market liquidity.

Question 4. Are the preliminary recommendations made in this report appropriate? Please explain and provide supporting evidence.

We generally agree with IOSCO's preliminary recommendations[17] and we are committed to helping market participants with the implementation of any resulting regulatory requirements in the IOSCO jurisdictions. We also agree with IOSCO that, to ensure that any post-trade transparency regime delivers the anticipated benefits whilst minimizing potential costs and risks, jurisdictions should carefully consider the below issues:

- Measures to protect market liquidity

    - IOSCO recommended for jurisdictions to carefully consider how to set "the maximum delay between time of execution and time of public dissemination of the price and volume of an individual CDS transaction" and "whether special rules are necessary for public dissemination of the price and volume of large or 'block' transactions and, if so, rules that determine what constitutes such a transaction."[18]

    - We agree that any post-trade transparency regime for CDS should provide for appropriate delays between the time of execution and the time of public dissemination of the price and volume of an individual CDS transaction, and it should also contain special rules for the public dissemination of the details of large or "block" transactions. Both such elements should be carefully calibrated taking

[15] Such transactions could be caused by a firm migrating to a new booking system or transferring a CDS portfolio internally to a different desk.
[16] With the exception of allocations that, if not properly accounted for, will result in an overstatement of the transaction count but not of overall transaction volumes.
[17] VII. Preliminary Conclusions and Recommendations. CR, p. 35.
[18] CR p. 35.

into account the liquidity of the underlying instrument and the size of the transaction but also technical factors.[19]

- We recommend that IOSCO encourage regulators to pursue a data-driven and principles-based approach to setting post-trade transparency requirements. The actions of the U.S. Securities and Exchange Commission (SEC) recently are instructive. In its Regulation SBSR - Reporting and Dissemination of Security-Based Swap Information rulemaking security-based swaps are to be reported within 24 hours after execution. [20] This approach is seen by the SEC as an interim phase before the SEC has adequate data to inform a more nuanced post-trade transparency policy.

- Confidentiality issues

  - IOSCO recommended for jurisdictions to consider "measures to ensure confidentiality of the identities of the market participants, which could include "capping" or "bucketing" the true notional size of the transaction, particularly in small or illiquid markets in which trading is concentrated in one or two key market participants" and "whether the potential for loss of confidentiality in small or illiquid markets may be less pronounced for CDS products that are frequently traded in other larger, more liquid markets."[21]

  - We agree that regulators should include provisions in their regulations designed to ensure the confidentiality of counterparty identities in order to secure their continued participation in the market and herewith protect market liquidity. Relevant measures to achieve this objective include the "capping" or the "bucketing" of the true notional size of the transaction. We agree that this issue is particularly relevant for instruments that are illiquid and in which trading is concentrated in a few key market participants. It may be less pronounced for CDS products that are frequently traded in more liquid markets such as on-the-run CDS indices.

- Phased-in implementation

  - IOSCO stated that jurisdictions may wish to consider implementing post-trade transparency requirements in phases, "focusing on the most frequently traded standardized products and/or the largest or most frequent market participants in earlier phases and on less frequently traded products and/or the smaller or less frequent market participants" thereafter."[22]

  - We agree that, given the degree of preparedness of different categories of market participants and differences in the level of product standardisation and electronification, implementing post-trade transparency requirements in phases will deliver significant benefits. As experience with the implementation of post-trade transparency regimes in several jurisdictions has shown,[23] a sensible approach to the phasing-in of such requirements would start with data collection which is necessary to identify what products are frequently traded and liquid in a jurisdiction vs. those that are not.

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[19] For example whether a transaction is executed electronically or over the counter.
[20] See Statement at Open Meeting Concerning Rules Regarding Security-Based Swap Data Repositories and Regulation SBSR, Jan. 14, 2015, http://www.sec.gov/news/statement/2015-spch011415mjw.html#.VNIIsi7ANH0.
[21] CR p. 36.
[22] CR p. 36.
[23] The CFTC adopted final rules requiring reporting and public dissemination of data related to swap transactions. Reporting and public dissemination of transactions in CDS referencing broad-based indices began on 31 December 2012 for transactions involving a swap dealer, on 28 February 2013 for transactions involving a major swap participant but not a swap dealer, on 10 April 2013 for transactions involving any other financial entity and on 1 July 2013 for all other swap transactions subject to regulation by the CFTC. Japan's Financial Instruments and Exchange Act (FIEA) introduces the legislative framework for reporting of OTC derivatives. Under the FIEA, the Financial Services Agency of Japan (JFSA) must publicly disseminate certain information regarding OTC derivative transactions that are subject to reporting requirements under the FIEA with a phased-in implementation.

After data is collected and analysed with due care, jurisdictions should consider imposing more demanding post-trade requirements to the most frequently traded standardized products and the most active market participants. Only once the regulator had the opportunity to review the effects of post-trade requirements on these liquid products it should consider imposing similar requirements on the less frequently traded products and smaller or less frequent market participants.

- International coordination

  - IOSCO recommended for regulators to consider "consulting with authorities in other jurisdictions as appropriate, recognizing that each member jurisdiction is best placed to judge the extent of any such consultation and the appropriate time and manner for enhancing post-trade transparency for CDS that trade in its respective market."[24]

  - Based on our experiences we strongly urge regulators consulting with authorities in other jurisdictions and, to the extent possible, harmonize their requirements internationally. However, we also believe that each member jurisdiction is best placed to judge the extent of any such consultation and the appropriate time and manner for enhancing post-trade transparency for CDS that trade in its respective market.

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We hope that our above comments are helpful to IOSCO. 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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[24] CR p, 36.