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IOSCO Consultation Report: Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives

Dear Sirs,

We welcome the publication of IOSCO Consultation Report on the *Risk Mitigation Standards for Non-Centrally Cleared OTC Derivatives* (the "***Consultation Report***" or "***CR***") and we appreciate the opportunity to provide you with our comments.

Markit is a provider of financial information services to the global financial markets, offering independent data, valuations, risk analytics for internal capital models, and related services across regions, asset classes and financial instruments. Our products and services are used by numerous market participants to reduce risk, increase transparency, and improve the operational efficiency in their financial markets activities.[1]

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 100 comment letters to regulatory authorities around the world and have participated in numerous roundtables. We also regularly provide the 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.

Comments

Our comments are based on the experiences we have gathered over the years by offering a variety of risk mitigation services in the OTC derivatives markets, including confirmation,[2] valuation, and portfolio compression to participants across regions and asset classes. Specifically, our services in these areas are as follows:

- Confirmations

[1] Please see www.markit.com for further information.
[2] Through MarkitSERV, a wholly owned subsidiary of Markit Group Limited, which provides a single gateway for OTC derivatives trade processing. Please see www.markitserv.com for additional information.

- Markit's derivatives processing platforms facilitate the confirmation, matching and processing of OTC derivative transactions across regions and asset classes, including interest rate, credit, equity and foreign exchange, and provide universal middleware connectivity for downstream processing such as clearing and reporting. Specifically, the MarkitSERV platforms a) facilitate the agreement[3] between parties on the details of the transactions that they have entered into, b) provide them with connectivity to CCPs[4], trading venues and inter-dealer brokers, trade repositories, and the whole range of counterparties, including buyside and sellside, and c) report the relevant transaction and counterparty details to trade repositories under newly established regulatory requirements.[5][6]

- Valuations
    - Markit provides independent and transparent valuation services.[7] We offer independent valuations for OTC derivatives, private equity investments, structured notes and cash products, as well as a web-based platform for aggregating internal and independent marks.

- Portfolio compression
    - Markit offers compression services for portfolios of single name credit derivatives. Such compressions reduce the overall gross notional size and number of outstanding contracts without changing the overall risk profile or the present value of the portfolios. These objectives are achieved by terminating existing trades and replacing them with a small number of new replacement trades that carry the same risk profile and cashflows as the initial portfolio.

On the basis of our experience in providing these risk mitigation services we strongly support IOSCO's objective of risk mitigation in the OTC derivatives markets by promoting legal certainty, facilitating the management of counterparty credit and other risks and increasing overall financial stability. We welcome the publication of the Consultation Report and we generally agree with IOSCO's goals and standards as listed in the report. In our below comments we suggest some improvements that IOSCO could make to its proposed standards in the areas of trade confirmation, valuation with counterparties and portfolio compression in order to better achieve its objectives.

Standard 3: Trade confirmation

IOSCO states that "covered entities should establish and implement policies and procedures to ensure the material terms of all non-centrally cleared OTC derivative transactions are confirmed as soon as practicable after execution."[8]

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[3] Depending on the asset class and the type of execution, different methods will be used to achieve such "agreement" including affirmation/confirmation or matching.

[4] Our processing platforms are currently connected to, or are planning to connect to, more than 10 CCPs around the globe and in various asset classes.

[5] For the reporting of derivatives transaction to Trade Repositories, the MarkitSERV platforms are now live in Europe, the United States, Japan, Hong Kong, Australia and Singapore.

[6] Such services that are offered also by various other providers are widely used by participants in the global OTC derivatives markets today and are recognised as tools to increase efficiency, reduce cost, and secure legal certainty. With globally over 1,500 firms using the various MarkitSERV platforms that process, on average, 80,000 OTC derivative transaction processing events every day, our legal, operational, and technological infrastructure plays an important role in supporting the OTC derivatives markets in Europe, North America, and the Asia-Pacific region.

[7] Markit Portfolio Valuations is an industry validated, fully hosted service that provides independent valuations and risk measures for vanilla and exotic derivatives, private equity investments, structured notes and cash products. Our valuations are distributed via a single platform alongside clearing prices and counterparty marks.

[8] IOSCO CR, Standard 3.

We agree with IOSCO that the timely confirmation of OTC derivatives transactions is an important objective for the purposes of risk mitigation. However, we believe that some aspects of the standards proposed by IOSCO may not be sufficiently complete or clear to achieve the desired risk mitigation.

a) Confirmation of "material terms"

IOSCO states that the "material terms" of the derivatives transaction should be covered in the confirmation whilst it also presents a list of "possible material terms" in the Annex.[9]

Our experience has shown that to best mitigate the risk that is inherent in reaching an agreement on the details of an OTC derivatives transaction, its confirmation should cover *all* terms of the transaction and not just a limited number of "material terms". IOSCO should note that this view has been reflected already in the confirmation requirements that have been established in several major jurisdictions where more terms are required to be confirmed than those that are proposed by IOSCO.[10] Specifically, under the CFTC's final rules as well as under the SEC's proposed rules,[11] a confirmation reflects an agreement on *all of the terms* of the transaction.[12] We believe that limiting the confirmation requirement to only the key economic terms would only create unnecessary risks.

b) Timeliness of the confirmation

We generally welcome the timeliness requirement as proposed by IOSCO.[13] Based on our experience in providing counterparties with electronic means to confirm their OTC derivatives transactions in a timely and efficient manner we believe that IOSCO should require a transaction to be confirmed as soon as technically possible following its conclusion, and no later than 24 hours following its conclusion for a transaction where electronic means of confirmation are available. However, we believe that when setting the actual timeliness limits, regulators should differentiate between different categories of derivatives transactions hereby taking into account various factors such as the nature of the counterparties and the product or asset class.[14]

c) Scope of the confirmation requirement

We believe that to effectively reduce systemic risks, the scope of the confirmation requirement should be more clearly defined and broadened. Any requirement to confirm derivatives transactions should hence apply not only to non-centrally cleared OTC derivatives but also to transactions in cleared, or to-be-cleared, derivatives.

More specifically, in the context of transactions that are ultimately centrally cleared, we encourage IOSCO to clarify whether its standards for confirmation refer to the alpha and/or the beta/gamma trades.[15] We further recommend that IOSCO distinguish between derivatives transactions that are: (1) intended to be cleared at the time of execution and which may not result in a bilateral contract, and (2) transactions that either remain

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[9] IOSCO CR, Annex 1.

[10] For example, the CFTC's "Confirmation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants." 77 Fed. Reg. 55904. September 11, 2012.

[11] "Trade Acknowledgment and Verification of Security-Based Swap Transactions." 76 Fed. Reg. 3859. January 21, 2011.

[12] *See* 17 C.F.R. § 45.1 ("*Confirmation data* means all of the terms of a swap matched and agreed upon by the counterparties in confirming the swap. For cleared swaps, confirmation data also includes the internal identifiers assigned by the automated systems of the derivatives clearing organization to the two transactions resulting from novation to the clearing house.").

[13] Confirmation to occur "as soon as practicable after execution of the transaction." IOSCO CR, Standard 3.

[14] For example, an end-user with mid- to low transaction volume who does not have "matching" or more sophisticated technological capability may find it challenging to electronically "affirm" or "click-agree" transactions in very stringent timeframes. Such users may even need several levels of internal approval before being able to agree on a legal confirmation.

[15] Transactions that are ultimately cleared will typically originate from an uncleared transaction between the two counterparties (the so-called "alpha trade") which is then replaced (through novation) with two cleared transactions where these counterparties are facing the CCP (the so-called "beta" and "gamma" trades).

uncleared or are later cleared on a voluntary basis and which result in a bilateral contract temporarily or for the life of the transaction between the executing parties. In our experience, the terms of the confirmation for an intended-to-be-cleared transaction will generally be very similar to the cleared transaction, and would exclude bilaterally specific information such as master agreement type and transaction-specific credit terms. Transactions priced to clear may be traded under an execution agreement rather than under a master agreement, as bilateral transactions are.

IOSCO states that "only non-centrally cleared OTC derivatives transactions between two covered entities are subject to the standards in this report"[16] and encourages covered entities to "meet the relevant standards in this report" for "transactions between covered entities and non-covered entities".[17] From a risk mitigation perspective, we believe that it would be useful to establish requirements also for transactions between dealers and their end user clients (who are not covered entities), especially for the timely confirmation standard.

d) The use of "negative affirmation"

In the Consultation Report, IOSCO envisions authorities allowing parties to negatively affirm trades in lieu of agreeing on a bilateral confirmation.[18] Negative affirmation is the process whereby a unilateral communication, typically from a "dealer" (the "sending party"), containing the terms of a trade (as represented by the dealer) is deemed to be the legal confirmation of the trade if the client (the "receiving party") does not object to the terms of this communication within a certain period of time.[19]

IOSCO should note that, for a number of reasons,[20] the use of negative affirmations can cause increased risks. Whilst negative affirmation does not generally speed up the confirmation process,[21] any disagreements about trade details may not be flagged until there is either a cash break or it is picked up by a margin failure or by portfolio reconciliation. This will result in significant operational risk for both parties that will also contribute to systemic risk.[22] With IOSCO's stated goal to "improve legal certainty of the material terms of non-centrally cleared OTC derivatives transactions"[23] it may hence not be appropriate for IOSCO to generally accept such practice.

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[16] IOSCO CR, 1.3.

[17] IOSCO CR, 1.6.

[18] "Negative affirmation may be used as long as the outcome of the confirmation is legally binding on both parties." IOSCO CR, 3.6.

[19] Letter from the Operations Management Group to the New York Federal Reserve Bank, Equity Derivatives Market, Equity Financing Swap Roadmap, Dec. 10, 2008, at 1-2, available at http://www.newyorkfed.org/newsevents/news/markets/2008/12102008_letter.pdf.

[20] First, a confirmation may not reach the receiving party at all. The receiving party does not reject this trade, because it is never made aware of it, but the trade is regarded as confirmed by the sending party. Second, there is risk when a confirmation sent by the sending party reaches the receiving party but the receiving party disputes the confirmation details. The original sending party may not receive the dispute notice, so believes the original trade is confirmed, and the receiving party may believe the revised terms have been confirmed. Third, the client might not review the details of the communication it has received from the dealer at all or only at a rather superficial level, e.g. by checking only certain familiar terms.

[21] Assuming that the negative affirmation process affords the client adequate time to review the communication received from the dealer, would do nothing to speed the processing of a trade since it would likely take as much time to review a trade in a negative affirmation context as it would in a bilateral confirmation context.

[22] See e.g., U.S. Financial Crisis Inquiry Commission Report, at 243, available at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf ("Remarkably, top AIG executives, including CEO Martin Sullivan, CFO Steven Bensinger, Chief Risk Officer Robert Lewis, Chief Credit Officer Kevin McGinn, and Financial Services Division CFO Elias Habayeb—told FCIC investigators that they did not even know about these terms of the [credit default swaps AIG had written that provided protection on super-senior tranches of multisector CDOs backed mostly by subprime mortgages] until the collateral calls started rolling in during July [2008].").

[23] IOSCO CR, 3.3. See also FSB, Implementing OTC Derivatives Market Reforms: Report of the OTC Derivatives Working Group, Oct. 20, 2010, at 47, available at http://www.financialstabilityboard.org/publications/r_101025.pdf ("authorities should ensure that market participants report and TRs collect and provide data of the highest reliability practicable"). While this statement from the FSB relates to the reporting of OTC derivatives data to trade repositories, we think it would be incongruous for authorities to require rigorous accuracy for reporting purposes and to allow for less rigorous confirmation standards.

The lack of a positive feedback loop in the negative affirmation process is cured in the bilateral confirmation process. Authorities should therefore generally be encouraged to require counterparties to transactions to bilaterally confirm all of the terms of a transaction as this process encourages both parties to exercise greater diligence as compared to the negative affirmation process. IOSCO should note that bilateral confirmation is the market standard for most OTC derivatives asset classes and is currently required under the Dodd-Frank Act.[24] Nevertheless, with negative affirmation the current market practice in some small product segments of the OTC derivatives markets, typically simple products with very few confirmable parameters, IOSCO might consider providing a certain degree of flexibility in its standards. Specifically, national regulators might want to reflect the availability of different techniques for the confirmation of the various derivative products, whilst they should not actively encourage market participants to make use of negative affirmation for more complex products and/or in situations where other, more reliable ways of confirmation are available today.[25]

e) Electronic confirmation

We note that IOSCO does not provide guidance regarding the use of "electronic confirmation" in the Consultation Report. We believe in order to best harmonize confirmation requirements globally, IOSCO should encourage the use of electronic confirmation as is recommended in some jurisdictions. For example, under EMIR "An OTC derivative contract concluded between financial counterparties or non-financial counterparties….and which is not cleared by a CCP shall be confirmed, where available via electronic means, as soon as possible…".[26]

By endorsing such approach IOSCO would present a clear preference for the electronic confirmation of transactions whilst not precluding counterparties from using non-electronic means to confirm the transaction where necessary.[27] In order to best reduce risk and provide for global harmonization we recommend IOSCO follows what is already market practice and state a clear standard for electronic confirmation unless unavailable.

Standard 4: Valuation with counterparties

IOSCO proposed requiring covered entities to "agree on and clearly document the process and/or methodology for determining the value of each non-centrally cleared OTC derivatives transaction at any time from the execution of the transaction to the termination."[28] This requirement aims at aiding resolving valuation discrepancies in a timely manner thus reducing risk.

We agree with IOSCO that disputes about the valuation of derivatives transactions can be a significant source of systemic risk and they should therefore be either avoided or at least be resolvable within a limited period of time. Achieving this objective is particularly relevant given the upcoming margin requirements for uncleared derivatives that will require both initial and variation margin to be calculated and collected/posted daily. We appreciate IOSCO's statement regarding the use of third parties for the provision of portfolio valuations.[29] We believe that regulators must be able to ensure that valuations are not only reliable but also unambiguous and

[24] *See* Commodity Exchange Act, section 21(c)(2) (swap data repositories "shall confirm with *both* counterparties to the swap the accuracy of the data that was submitted." (emphasis added)). *See also* Swap Data Recordkeeping and Reporting Requirements, 75 Fed. Reg. 76,574, 76,581 (Dec. 8, 2010).
[25] The use of negative affirmation is less certain than bilateral confirmation as there is no positive feedback loop.
[26] EMIR Article 12: Timely confirmation.
[27] "Electronic confirmation may be available to the market (e.g. confirmation platforms) but not to a specific counterparty for a variety of legitimate reasons. If the counterparty is able to justify that electronic confirmation is not available to it, then confirmation may be performed by fax, paper, or manually processed emails." ESMA Questions and Answers: Implementation of the Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR). Question 5.
[28] IOSCO CR, Standard 4.
[29] IOSCO CR, 4.2.

consistent across jurisdictions, trade repositories and instruments. Experience has shown that the use of "independent" valuations[30], i.e. valuations that are provided by parties other than the counterparties to the transaction, can represent a key element to achieve this objective.

Standard 6: Portfolio compression

We are generally supportive of IOSCO's proposed standard related to portfolio compression. Specifically, IOSCO proposes requiring covered entities to "establish and implement policies and procedures to regularly assess and, to the extent appropriate, engage in portfolio compression."[31]

For many years Markit has offered portfolio compression services that reduce the overall gross notional size and number of outstanding single name credit derivative transactions without changing the overall risk profile or present value of such portfolios.[32] On that basis we recognize the benefits and the importance that post-trade compression has on reducing the risk and transactional inefficiencies in non-centrally cleared derivatives portfolios. We therefore generally support the broader application of current portfolio compression capabilities. That said we also welcome IOSCO's acknowledgment that, given the cost/benefit ratio, it might not be appropriate to require portfolio compression in some situations.

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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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[30] For example, Markit Portfolio Valuations. Markit Portfolio Valuations is an industry validated, fully hosted service that provides independent valuations and risk measures for vanilla and exotic derivatives, private equity investments, structured notes and cash products. Our valuations are distributed via a single platform alongside clearing prices and counterparty marks.
[31] IOSCO CR, Standard 6.
[32] Since August 2008, Markit/Creditex Portfolio Compression services have reduced gross notional by USD 8.7 trillion and reduced trade count by 1.3 mm.