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19th March 2012

ESMA
103 rue de Grenelle
75007 Paris
France

Submitted via www.esma.europa.eu

Re: **Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories**

Dear Sir/Madam,

Markit[1] is pleased to submit the following comments to ESMA in response to its Discussion Paper on the Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories (the "***Discussion Paper***").

Introduction

Markit is a service provider to the global financial markets, offering independent data, valuations, risk analytics, and related services for OTC derivatives and other financial products across regions and asset classes. Our products and services are used by a large variety of market participants to reduce risk, increase transparency, and improve operational efficiency in their financial markets activities.

Markit supports ESMA's objectives of reducing the risks that are associated with the OTC derivatives markets and of establishing common rules for central counterparties ("***CCPs***") and trade repositories ("***TRs***") as required by the Regulation on OTC Derivatives, CCPs and Trade Repositories (the "***Regulation***"). As a matter of principle, we recommend for ESMA to employ a non-prescriptive approach to drafting the Technical Standards that would allow market participants to utilize efficient and cost-effective solutions to satisfying a requirement. This should include the use of existing infrastructure and delegation to appropriately qualified third parties. Such approach will in turn not only encourage market participants to identify the best solutions to comply with the various requirements but it will also facilitate the implementation of such requirements in a timely and cost-effective manner. That said, please find below more specific comments in relation to Risk mitigation for non-CCP cleared contracts (marking-to-market/marking-to-model and portfolio compression); CCP requirements (CCP investment policy, in particular appropriate liquidity measurement); and Trade Repositories (reporting of mark-to-market values to TRs).

1. Risk mitigation for non-CCP cleared contracts (Articles 6/8)

1.1. Marking-to-market and marking-to-model

Question 14: In your views, is the definition of market conditions preventing marking-to market complete? How should European accounting rules be used for this purpose?
Question 15: Do you think additional criteria for marking-to-model should be added?

[1] Markit is a financial information services company with over 2,400 employees in Europe, North America, and Asia Pacific. The company provides independent data and valuations for financial products across all asset classes in order to reduce risk and improve operational efficiency. Please see www.markit.com for additional information.

Based on our experience as a provider of valuation services for OTC derivatives and other financial products across asset classes, regions, and products[2] we generally believe that there is no bright line between situations where one can mark-to-market and where one should be allowed to mark-to-model. Instead we would look at the use of observable inputs and models as a continuum, and the decision which approach to use will be made on the basis of the individual user.

When defining which transactions can be marked-to-model, we believe that, in this context, ESMA should consider that the availability of reliable pricing information is only one of the many pre-conditions for a derivative contract to be cleared, and the fact that a contract is not centrally cleared does not necessarily imply that no reliable pricing information is available.

ESMA should consider that marking-to-model introduces an increased level of subjectivity into the valuation process. The Regulation might therefore have the unintended consequence of allowing, or even encouraging, participants to just use their own model and inputs to produce a valuation in certain circumstances, thereby disregarding meaningful observable inputs. We therefore support ESMA's proposed approach that, in situations where marking-to-model was permitted, it should be "reliable" and "prudent", and market participants would still need to take "any available observable market data" and "all factors that counterparties would consider in setting a price" into account. We further support the requirement for the unit that performs the valuation to be independent of the risk taking unit, which seems in line with market best practice. We believe that such requirements can be helpful to ensure that the use of mark-to-model will not result in valuations being manipulated or not reflecting the "real" value of the position.

To enable a timely and cost-efficient implementation of the requirement to perform a daily mark-to-market or mark-to-model for all positions in derivatives that are uncleared, we believe ESMA should explicitly allow market participants to delegate the daily mark-to-market or mark-to-model calculation for their positions to appropriately qualified third parties.

1.2. Portfolio Compression

Question 17: What are your views regarding the threshold to mandate portfolio compression and the frequency for performing portfolio compression?

We agree with ESMA's view that Portfolio Compression ("***Compression***" or "***PC***") is a useful, risk-reducing exercise that should be performed on a regular basis. However, based on the experience that we have gathered as a provider of Portfolio Compression services over many years,[3] we believe that ESMA should carefully consider the cost and benefits of performing Compression for derivatives transactions before mandating it.

We generally believe that performing risk-neutral Compression for centrally cleared OTC derivatives will almost always be worth the cost because compressing a portfolio of centrally cleared transactions in a risk-neutral manner is fairly straightforward. However, the issue is somewhat more complicated for OTC derivatives that remain uncleared:

Costs

[2] Markit's Portfolio Valuations service currently provides around 70,000 derivatives valuations per day to its clients that include the leading fund administrators and investment managers. We provide valuations for individual derivatives across all asset classes, including exotic products, as well as CCP settlement prices for Credit Default Swaps ("***CDS***") and credit indices.

[3] Markit, in conjunction with Creditex, launched the first fully risk-neutral Portfolio Compression process for single name CDS in August 2008. Through the use of sophisticated algorithms and the creation of a small number of new swaps transactions, it enabled participants to complete a Portfolio Compression cycle without any change in their risk profile. Because a much higher level of participation and Compression efficiency can be achieved through such multilateral risk-neutral Portfolio Compression approach, this process has established itself as the standard for CDS indices and single-names. To date, we have completed more than 200 weekly Portfolio Compression cycles in the Europe and in the United States that included a total of 900 single name CDS. This Compression activity has successfully removed a total notional amount of close to $7 trillion of economically redundant single name CDS transactions.

The most active dealers currently participate in regular compression cycles for certain derivative products and, in doing so, have established the appropriate operational infrastructure for such products. However, we believe that any general requirement for a large number of counterparties to perform Portfolio Compression could impose significant additional burdens on (i) parties that currently do not participate in Compression cycles, and (ii) on all parties for those products for which Compression cycles are currently not performed. Based on our experience, the operational and technological preparation that is required from counterparties to allow them to participate in Portfolio Compression cycles can be very demanding. [4] Processes and procedures must be established by each of those counterparties to allow efficient and timely validation and execution. This typically requires changes to the participant's risk systems and connectivity enhancements to platforms that enable the confirmation of the transactions that were executed as a result of the Compression cycle.

Benefits

A number of recent initiatives have been aimed at performing Portfolio Compression in other asset classes, such as foreign exchange and commodities. However, ESMA should note that little benefit was obtained from these exercises except for those OTC derivatives that were already in scope for central clearing. Given the operational burden of participating in Compression, we believe that any requirement to participate in Compression cycles would need to take into account additional variables that are designed to ensure that such Compression cycles will only be performed if they create at least a minimum level of benefit.

That said, we welcome ESMA's willingness to allow even counterparties with larger portfolios to not participate in a Compression cycle as long as they can provide a "reasonable and valid explanation". We believe that such approach would allow participants to reflect the actual benefit of participating in Compression cycles which will depend on numerous factors which are difficult to explicitly capture in a regulatory framework:

- Generally, the potential to remove economically redundant transactions for a given product and the challenges to perform Compression cycles depend on several product specific variables. These are, for example, the number of counterparties with outstanding positions, the total number of outstanding transactions in the product, the number of transactions held by each counterparty, the amount of ongoing trading activity, and the differences between individual transactions.

- Further, the amount of Compression that can actually be achieved will often deviate significantly from the gross potential:

    - Even though overall Portfolio Compression is risk-neutral related to the underlying risk, the exposure to the individual counterparties that participate in a given cycle is not. The amount of Compression that can be performed will therefore often be limited by the counterparty risk limits.
    - Many positions in OTC derivatives cannot be characterized by the use of standard trades and therefore cannot be compressed.[5]
    - Market participants will often use OTC derivatives as specific hedges against other positions, and must therefore be allowed to withhold such transactions from Compression cycles.

These and other factors in combination limit the potential to actually compress transactions, and the benefit it might deliver in many asset classes and products will not always justify its cost. We therefore generally

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[4] For example, some of the Compression cycles that we perform create the need for participants to book and process up to 5,000 single name CDS transactions on a single day. This represents a significant operational challenge, particularly seen in the context of the 40,000 CDS transactions that are executed on average per month. *See* the Quarterly Metrics for further details related to average monthly volumes of the G14 dealers, available on http://www.markit.com/en/products/research-and-reports/metrics/metrics.page .

[5] For example, it might not be possible to re-create an existing deeply in- or out-of-the-money net swap position by using standard derivatives.

support ESMA's careful approach to determining whether a participant should be subject to mandatory Compression. We would expect participants that breach the thresholds to be in the best position to judge and explain to ESMA why a Compression exercise for their portfolios might not be appropriate, and believe this approach is preferable to one where ESMA was trying to establish additional, more specific variables.

Frequency

Based on our experience, we believe that the ideal frequency of Compression cycles will depend on the benefit that it would deliver for each cycle, which itself is often a function of product specific variables such as the level of ongoing activity.[6] We would therefore recommend that the frequency of Compression cycles be equally dependent on the measure of Compression benefit and the use of thresholds as explained above.

Finally, it is worth highlighting that there are a number of issues that ESMA will need to be further clarify in relation to Portfolio Compression.[7]

2. CCP Requirements

Collateral Requirements (Article 43) and Investment Policy (Article 44)

Question 44: Do you consider that financial instruments which are highly liquid have been rightly identified? Should ESMA consider other elements in defining highly liquid collateral in respect of cash of financial instruments? Do you consider that the bank guarantees or gold which is highly liquid has been rightly identified? Should ESMA consider other elements in defining highly liquid collateral in respect of bank guarantees or gold?

Question 51: Do you consider that financial instruments and cash equivalent financial instruments which are highly liquid with minimal market and credit risk have been rightly identified? Should ESMA consider other elements in defining highly liquid financial instruments with minimal market and credit risk? What should be the timeframe for the maximum average duration of debt instrument investments?

The measurement of liquidity of financial instruments is a challenging task, not only at a given point in time, but even more so given that market conditions evolve over time. That said, we generally agree with ESMA's view that a criteria-based approach to the measurement of liquidity is preferable to defining a list of financial instruments that shall be considered highly liquid with minimal market and credit risk.

However, we believe this criteria-based approach could be further improved upon. For example, the DP states that debt instruments are acceptable which "have an active outright sale or repurchase market at all times with a diverse group of buyers and sellers" and "have price data published on a regular basis." While we agree that these factors are related to the liquidity of the instruments, they may be insufficient to properly measure the liquidity of the instruments in question and difficult to quantify. Our experience as a

[6] For single name Credit Default Swaps, we have performed Portfolio Compression cycles on a weekly basis for a number of years. Typically, up to 50 reference entities would be included in any given cycle, and each single name credit is part of a Compression cycle every 2 to 6 months, depending on activity in that name. We continue to see sufficient interest from market participants in these exercises, and are thus planning to continue offering Portfolio Compression cycles with such frequency going forward.

[7] Open questions include, for example: 1.Does the threshold of 500 or more transactions apply to the entire portfolio, i.e. across asset classes and products? How does it apply to participants that allocate their transactions to individual funds? Will each position count separately as transaction? 2. On what level does the requirement to terminate fully offsetting contracts apply? ESMA should consider situations where transactions are used as a hedge and an unwind of the position can therefore not be performed. 3. The requirement for Compression to be performed by participants "especially when they already use" Compression services risks creating negative incentives for market participants to start performing Portfolio Compression on a voluntary basis and should hence be reconsidered.

provider of Liquidity Scores for a variety of financial products[8] has shown that, although creating liquidity measures for products that trade mainly over-the-counter is complicated, they can be derived from a combination of observable factors including, but not limited to, trade frequency, average transaction size, bid/offer spread and the number of market makers. We would be happy to further discuss these issues with ESMA if so desired.

3. Trade Repositories

Reporting obligation (Article 6/7)

Question 78: Given that daily MTM are required to be calculated by CPs under [Article 6/8] of EMIR, how complex would it be to report data on exposures and how could this be made possible, particularly in the case of bilateral trades, and in which implementation timeline? Would the same arguments also apply to the reporting of collateral?

We believe that TRs in general will not be in a position to calculate daily valuations for all of the positions in OTC derivatives that they hold. This view is based not only on the amount of information that they currently capture and their current capabilities, but also on the ability to capture all relevant information or build valuation capabilities for the whole range of products in the future. We therefore agree with ESMA's suggestion that, as financial CPs and non-financial CPs above the threshold have an obligation to mark-to-market their exposures on a daily basis under Article 6, it might be more appropriate to consider the reporting of these daily mark-to-market values to the TRs. It is worth noting that mechanisms are already in place for market makers in the derivatives markets to communicate daily marks to their counterparties in an efficient, secure, and auditable fashion, and that such mechanisms could also be employed to facilitate the reporting of daily marks to TRs.

We believe the proper assessment of counterparty risk and ensuing systemic risk from a regulatory perspective would be most accurate if additional pieces of information in relation to the actual exposure, e.g. collateralization, netting agreements, and margin payments could also be taken into account. We believe that ESMA and other regulatory authorities should take this into consideration in order to achieve this objective.

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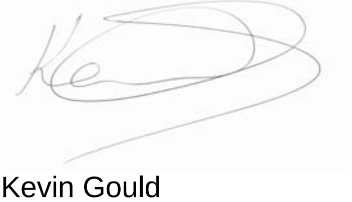
We appreciate the opportunity to comment on ESMA's Discussion Paper on the Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories, and we thank ESMA for considering our comments. In the event you may have any questions, please do not hesitate to contact the undersigned or Marcus Schüler at marcus.schueler@markit.com .

Sincerely,



Kevin Gould
President
Markit North America, Inc.

[8] Markit provides liquidity measures, based on a number of relevant inputs, for a variety of OTC derivatives, bonds, loans, and structured finance instruments.