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November 7, 2011

Ms. Elizabeth Murphy
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Re: **Use of Derivatives by Investment Companies under the Investment Company Act of 1940 (File Number S7–33–11)**

Dear Ms. Murphy,

Markit[1] is pleased to submit the following comments to the Securities and Exchange Commission (the "***SEC***" or the "***Commission***") on the concept release in relation to the Use of Derivatives by Investment Companies under the Investment Company Act of 1940 (the "***Concept Release***").[2]

Introduction

Markit is a service provider to the global derivatives markets, offering independent data, valuations, risk analytics, and related services for over-the-counter ("***OTC***") derivatives across regions and asset classes in order to reduce risk, increase transparency, and improve operational efficiency in these markets. As such, we are also an important provider of independent valuations for swaps, security-based swaps ("***SB swaps***"), and other financial products to fund managers, both in the United States and internationally.[3]

Executive Summary

Our comments focus on the manner in which funds (as defined in the Concept Release) value their positions in derivatives and measure the inherent uncertainty of these valuations. Both of these activities will typically rely on the use of judgment and therefore create challenges for funds, their investors, and their regulators. As explained in more detail below, we believe that the Commission could address these challenges by: (1) adopting existing best practice standards for valuations by requiring them to be (a) calculated by entities that are independent, (b) based on multiple inputs where available, (c) communicated through secure and auditable means, and (d) valuations that form the basis for determining whether a fund is diversified or not should reflect the risks involved; and (2) requiring funds to provide their investors with transparency about (a) the inherent uncertainty of their valuations, and (b) the liquidity risk of their positions.

1. The Commission Should Adopt Market Best Practices In Relation To The Valuation of Derivatives

The Commission requested comment on several questions regarding the valuation of derivatives, such as how to determine fair value, how to assess the accuracy of source data, and whether it should issue

[1] Markit is a financial information services company with over 2,300 employees in North America, Europe 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.

[2] Use of Derivatives by Investment Companies under the Investment Company Act of 1940, 76 Fed. Reg. 55237 (published Sept. 7, 2011).

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

guidance on how funds should determine fair value.[4] We agree that the valuation of derivatives presents challenges for funds because there is no single methodology that would be appropriate for determining the fair value of each of these financial instruments,[5] and also because there is no single authoritative source of pricing data. For example, when valuing derivatives that do not have readily available market quotations, funds sometimes obtain valuations from an independent third-party source while, at other times, they source valuations from an internal party like the fund's trading desk. Matters are complicated further because of the conflicts of interest that may arise when valuations are provided to the fund by parties that might have a financial interest in the level at which the transaction is valued.

On the basis of our experience in providing valuations for a wide variety of financial instruments, we provide below an overview of certain issues that we believe are relevant to the valuation of derivatives by fund managers. We do so based on the belief that ensuring the accuracy of those valuations and creating sufficient transparency about some of the major risks that are inherent in them will be beneficial to investors in funds, to the Commission, and to the public.

a) Valuations Of Derivatives Should Be Sufficiently Independent

The regular occurrence of significant "trading losses" that are related to the inaccurate valuation of positions in financial instruments has highlighted the need for users and regulators alike to protect against derivatives valuations being exposed to conflicts of interest. We believe that the risk of the occurrence of incorrect valuations will persist as long as the holders of derivative positions can influence, in one way or another, where these positions are valued. Various industry organizations and regulators have therefore developed best practices for the valuation of financial instruments that include requirements for valuations to be independent.[6]

Valuations will typically be regarded as independent if they are provided by independent parties, which can be either separate units of the fund or independent third-party providers ("***ITPPs***"). ITPPs do not trade or take positions themselves and therefore have no financial interest in the valuations that they distribute to their users. Further, the valuations that are provided by ITPPs tend to offer several additional advantages to funds, their investors, and their regulators. For example:

- ITPPs typically use multiple sources of pricing such as exchanges, CCPs, counterparty marks and independent pricing services. They are therefore able to eliminate most errors and bias to create a representative view of the appropriate valuation;
- ITPPs are experienced in developing, calibrating, and deciding on the use of the appropriate valuation models;[7]
- Many ITPPs offer substantial transparency into the methods and inputs that they used to produce valuations as well as their inherent risks;[8]

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[4] *See* Concept Release, 76 Fed. Reg. at 55255.

[5] *Id.*

[6] See, for example, AIMA Guide to Sound Practices of Valuation, March 2007; Circular to notify undertakings for collective investment in transferable securities (UCITS), August 2007

[7] The use of a valuation model is necessary to produce a valuation for most swaps, and the choice of an appropriate model will therefore impact the reliability of the resulting valuations. While Markit tends to use industry standard pricing models, the regular re-calibration of such models to observed prices, the active monitoring of price challenges, and the ongoing dialogue with industry participants ensures the consistency of these models with industry standards. Often, the timely adjustment of valuation methodologies will be required to reflect distressed markets or changes in industry pricing practices.

[8] For example, we will provide our clients with documentation that creates transparency around the inputs, valuation techniques and assumptions that we use in producing our valuations.

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- Many ITPPS have established procedures to provide valuations as of specific snap times as requested by the client;[9] and
- ITPPs are often SAS 70 accredited, which serves to ensure the quality, security and integrity of the valuations that they provide.

Most fund managers already make use of independent valuations today for their positions in derivatives and other financial instruments. Because of the benefits described above and the elimination of conflicts of interests resulting from the use of independent sources, we believe that the Commission should consider requiring funds to use independent sources for the valuation of their positions in financial products, including derivatives. Funds could satisfy such requirement by using valuations that are provided either by an independent unit of the fund or by one or several ITPPs.

b) Valuations Should be Based on Multiple Inputs Where Available

We generally agree with the Commission that a fund should use market quotations to value a position when they are readily available.[10] This is because, for actively-traded financial instruments such as certain exchange-traded products, a reliable price can often be readily and accurately ascertained based on market quotations.

However, we believe that the Commission should create a more granular definition of "market quotation" and "readily available" in order to avoid creating situations where certain derivatives would end up being incorrectly valued based on market quotations. For example, we often observe that, for less liquid exchange-traded derivatives, valuations based on OTC data for look-alike products provide a better representation of fair value than the actual exchange price. Indeed, many '40 Act funds solicit valuations for OTC products from ITPPs in order to verify the exchange price for their positions in exchange-traded derivatives. We therefore urge the Commission to clarify that, even when market quotations are available, funds should always use all pricing sources that seem relevant for the valuation of the derivative product.

For financial instruments that do not trade actively or trade mainly over-the-counter, market quotations are rarely readily available, and their valuation must therefore often be derived from other observable data points.[11] Based on our experience, we believe that such valuations will be more reliable if several sources of observable data are utilized because this helps to avoid the need to model inputs, to extrapolate, or to introduce any unnecessary assumptions. We therefore agree with the Commission that funds should take all available indications of value into account when determining the fair value of their positions, be it for positions in securities or in derivative products.[12] Such relevant sources should include counterparty marks[13] and valuations provided by ITPPs, where available, which would be in keeping with today's best practices.[14]

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[9] As the Commission's statement focuses on '40 Act funds, fair value as of the fund snap time is a key issue to be considered. Most funds calculate their Net Asset Value ("***NAV***"), and therefore the price at which investors can buy/redeem shares, as of a specific time during the day. It is therefore vital that the valuation of their derivatives positions is performed as of this time.

[10] Concept Release, 76 Fed. Reg. at 55255.

[11] If no observable data is available, the modeling of inputs or the discounting of expected future cash flows might be necessary.

[12] *See* Concept Release, 76 Fed. Reg. at 55255.

[13] Counterparty marks are often used as a useful additional piece of information to verify other pricing sources. The Commission should also note that workflow tools have been established that allow buy-side firms to compare counterparty valuations to independent valuations and to identify any discrepancies and track disputes in an efficient and timely manner.

[14] Markit's pricing and valuation services, for example, would typically take into account prices from exchanges and CCPs, from market makers' books-of-record, as well as from interdealer brokers. End-of-day book-of-record pricing services rely on contributors providing their marks at the end of each business day. This data is cleansed using

c) The Means to Communicate Transaction and Valuation Information Must Be Secure And Auditable

The means that are used to communicate the actual valuations to funds need to be sufficiently secure and auditable. We believe that this forms a pre-condition not only for securing the confidentiality of the client's position information but also for enabling the monitoring of valuation disputes and their resolution. For Markit's Portfolio Valuation Services, for example, transaction details are communicated by secure data feeds that are generated from the client's accounting and portfolio management systems, from Markit Valuations Manager, or from trade confirmation platforms. The use of such feeds is not only convenient for clients, but also ensures that the submitted data that is used to perform the valuation is indeed both accurate and complete.

We believe that in order to secure the confidentiality of transaction information and to enable the monitoring of price challenges and their resolution, the Commission should establish requirements for participants to use only appropriate means to communicate position information and actual valuations respectively.

d) Derivatives Valuations That Form The Basis for Determining a Fund's Classification as Diversified Should Be Based On A Comprehensive Reflection of Inherent Risks

As the Commission noted, a fund must calculate the value of its derivative positions in order to determine the total value of its assets, which will then form the basis for determining its classification as diversified or non-diversified.[15]

We believe that such valuations should reflect the following factors:

- The value of the derivatives that are taken into account should reflect exposure both to the issuer of the asset underlying the derivative and to the counterparty to the derivative contract.
- The value of the derivatives should reflect the correlation between the asset underlying the derivative and the counterparty of the derivative contract, where this effect is significant.[16]
- The models and methods that are used to value the derivative should reference the future expected value of the derivative and thereby take into account potential gains or losses based on future market moves. This is because the value of the derivative could change significantly over the life of the contract and a current exposure based approach may underestimate the risk of the derivative contract.

Further, we recommend that the Commission request market participants to report their exposure to industries by country and region when reporting portfolio concentration. This will help identify concentration in regional exposures.[17]

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standardized and transparent algorithms to eliminate the potential for error or bias, before composite datasets are formed. We also cross-validate and challenge the data from these various sources on an ongoing basis.

[15] Funds are required to disclose their status as diversified or non-diversified in their registration statements in order to prevent a fund that holds itself out as diversified from being too closely tied to the success of one or a few issuers or controlling portfolio companies. *See* Concept Release, 76 Fed. Reg. at 55250.

[16] The measurement of this effect can be challenging though, as for most derivative contracts the correlation between the underlying asset and the counterparty is not directly observable and there may not be a market standard to calculate it.

[17] For example, if a fund holds a bond portfolio that is not concentrated by industry but only contains emerging market issuers, such concentration should be highlighted to investors.

2. Funds Should Provide Sufficient Transparency About Inherent Valuation Risks

a) Measures of Valuation Uncertainty Should Be Created and Disclosed by Funds

We believe that the use of a multi-dimensional perspective on valuations is crucially important. We therefore appreciate that the Concept Release not only discusses how to ensure the accuracy of valuations, but also how to measure and disclose their inherent uncertainty.

We believe it would be beneficial if funds quantified the inherent risk of their valuations by providing the following information:

- Valuations should generally be accompanied by measures of their inherent uncertainty.[18] Because any valuation is exposed to some level of uncertainty, such disclosure should be provided regardless of whether the underlying product is exchange-traded, centrally cleared, or traded purely OTC.
- Users of valuation services should understand and be able to explain how the valuations that they use were created. ITPPs should therefore provide their clients with technical documents that contain information on the nature of the inputs, the valuation techniques, and the assumptions and details of the pricing models that they used in producing their valuations.
- Recipients of valuations must be able to challenge the valuations that they received from ITPPs. If they do so, the vendor should be required to provide them with details of a thorough investigation on a timely basis. It should also make its valuation experts available to discuss the vendor's underlying assumptions and results with the client in detail.

On that basis we believe that the Commission should require funds to use and monitor various measures of the inherent uncertainty of their valuations and disclose them to their investors on a regular basis.

b) The Liquidity Risk of Funds' Positions Should Be Measured and Disclosed

The Commission asked whether funds should be required to undertake an ongoing analysis of the liquidity of their positions in derivatives and requested comment on how liquidity of such positions evolves over time.[19]

Market liquidity is the ability of an investor to buy or sell an instrument near the market price with minimal price impact. In our experience as a provider of liquidity information for various financial products,[20] there are a variety of market, product, and firm specific factors that indicate market liquidity. They can include the bid/offer spread, market depth and resilience, the frequency of price updates, trading volume and the positions and counterparties of the specific firm.

Liquidity assessment for financial products is critical for a variety of functions such as trading, risk management, margin and capital management, because the liquidity of a position has a direct impact on the price and the speed at which it can be liquidated. Further, as noted in the ABA report, mutual funds typically disclose that no more than 15% of the fund's net assets may be invested in illiquid investments.[21] An increasing number of market participants are therefore using individual liquidity metrics or independently calculated liquidity scores.

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[18] Valuation uncertainty could be measured, for example, on the basis of the number of pricing sources or the range of the underlying contributions that were used as inputs.

[19] *See* Concept Release, 76 Fed. Reg. at 55247.

[20] Markit currently provides liquidity metrics and scores for CDS, asset-backed securities, bonds, and loans. They are based on data such as the number of market makers quoting, the number of quotes per day, the bid-offer spread, and the average size.

[21] Report of the Task Force on Investment Company Use of Derivatives and Leverage. Committee on Federal Regulation of Securities ABA Section of Business Law. July 6, 2010.

We believe that it would be beneficial for investors and the Commission if funds quantified and disclosed the liquidity of their positions in addition to their actual valuation.[22] Such disclosure would enable the funds themselves, their investors, and their regulators to develop a better understanding of the liquidity risks that individual funds are taking.

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We appreciate the opportunity to provide the Commission with our comments on the Concept Release. 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.

[22] We believe that this type of information would have relevance even for positions that are expected to be held to maturity.