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In the weeds on the rocky road to an electronic OTC market

Allan D Grody, president of Financial Intergroup Holdings, looks at the importance of the LEI for a functioning electronic OTC market and the challenges faced in its implementation.

The system to electronically identify, trade and clear swaps has been designed by the CFTC, albeit in "consultation" with the industry's many constituent and competing self-interests.

In summary, it is an attempt at designing an automated market that bridges the mechanisms of interoperability of the fragmented infrastructure of the equity market with the vertical silo structure of the listed futures markets.

The CFTC is struggling to do this in some rational way to get to a solid first landing of a complex product category that had been traded bi-laterally amongst dealers for decades. It all starts with labeling each counterparty uniquely and

The CFTC's aspirations for automating the OTC derivatives markets is still lacking conviction as the CFTC sets then postpones its many target dates for implementation over its many component parts.

The regulatory community, market participants and Commissioners at the CFTC are concerned in the final hours that we are moving too fast. Compounding the already complex regulations is the federal government's shut down, which has further complicated the ability of the CFTC to clarify its rulemaking going forward.

To begin this journey, the CFTC, the SEC and the US Treasury asked for a unique code back in 2010, the Counterparty Identifier Code. It is now called the LEI (Legal Entity Identifier). In the US it is the CICI – CFTC Interim Counterparty Identifier.

The momentum for implementing this bar code equivalent for financial services now comes from the G20, passed on from the US Treasury's Office of Financial Research to the G20's Financial Stability Board and now to the Regulatory Oversight Committee.

It will soon be passed to a Board of Directors that will make final decisions and implement a central core facility, yet to be described in any detail. The CICI, called a pre-LEI is being implemented as an interim step as part of the Global Legal Entity Identifier System (see www.LEIROC.org).

As an example of this code, here are the counterparty identifiers for just two of JPMC's transacting subsidiaries - CJXOP7I6D88DPFZ1LX66 for JP Morgan Chase Retirement Plan and 549300ZK53CNGEEI6A29 for JP Morgan AG.

There may need to be 4012 CICI codes assigned to JPMC when all components of the Global LEI System are fully operational, for Goldman 11078 legal entities, for Morgan Stanley 7986, etc. (See Federal Reserve's National Information Center at <http://www.fiec.gov/nicpubweb/nicweb/Top50Form.aspx> for the list of the top 50 bank holding companies legal entity hierarchies).

Also all financial intermediaries operating in the OTC space and all reference entities must also be identified in this same way (this is the CME's CICI legal identifier SNZ2OJLFK8MNNCLQOF39). Later on all financial market participants in the supply chain of all financial transactions will be labeled uniquely, not just participants in swaps markets.

The LEI is, in its first use, a pillar for transacting swaps in a computerised transaction environment. It is the glue that will make this possible, yet very few understand it.

Even a recent WSJ article, which does a very good job of accurately describing the current situation from the US perspective is devoid of any reference to the CICI. That is because it is the plumbing, and the C-suite are not inclined to go rummaging into the basement, hence reporters who write for influential publications like the WSJ don't get too close to the LEI. After all it is plumbing.

However, there are many hints that things may go wrong. The pre-LEIs, particularly the CICI may find itself as the most vulnerable piece of the infrastructure that no one cared about. Its facilities operator has already had to remove 20,000 previously assigned codes and registrations of legal entities, 3000 of which have already been used in trade reporting.

Labeling the same counterparty with the same CICI when it is the same legal entity is the first task. A duplicate of the same legal entity but with a different CICI code won't do. The same CICI code but different legal entities won't do either.

The aim is to have a unique, unambiguous and universal numbering scheme and quality data for describing the legal identity. Only lately has the ROC made it a requirement to have the legal entity self-register itself. The earlier approach allowed third party facilities operators to both register and code the legal entity. Now only the code is to be created and assigned by domestically approved facilities operators.

In many cases the data must be resident in the sovereign domicile of the registered entity. This compounds the data aggregation issue as multiple LEIs for a single ultimate parent will be spread across the world and across multiple proprietary data bases run by these facilities operators.

The current process can lead to complications as these codes are being requested in the same overall business entity by globally scattered individuals. It would make more sense for the CRO, CFO, Counsel or Compliance Officer of each business entity at the ultimate parent level to control these assignments centrally.

This will keep the internal codes synchronised to the external LEI codes, important when changes from mergers, acquisitions, spin-offs, etc. occur. Otherwise the result could be huge mapping tables and the same old risk problems as before.

As the focus is now self-registration and self-certification, a recent ROC announcement clarified these requirements (see http://www.leiroc.org/publications/gls/lou_20131003.pdf); the code and its supporting data can be both centrally coordinated and assigned by the financial market participant itself.

This is how we register and assign domain names through Internet Service Providers on the World Wide Web. We can get immediate feedback that tells us whether the code (domain name) is valid globally and that no duplicates have been registered.

Right now in the implementation of the interim Global LEI System large data files are passed amongst approved pre-LEI facilities operators daily so that duplicate checking can be done both internally and between them. Large data bases of all the LEIs are to be kept updated at each facility operator. Expanding this technique to all sovereign countries that support their own facilities operator can introduce more risk and costs than the alternate of having a simple internet based duplicate checking solution and a federated virtual view of all the component LEI data bases, as we now do when we do a Google search.

When the Board of the GLEIS is in place, perhaps the duplicate issue would be resolved, perhaps the assignment process reevaluated, perhaps even a virtual data base substituted for passing big data files around the globe.

Thereafter, getting trades to match via a globally unique counterparty identifier (CICI aka pre-LEI) through multiple trading venues and multiple CCPs for real-time STP is possible. Then as a byproduct, data aggregation of the LEI's swaps details across multiple SDRs is possible as well.

Finally, when trying to analyse systemic risk, which is the ultimate purpose of the Global LEI System, as in the "flash crash" and the "flash freeze" or in looking for the next systemic contagion all those individual LEIs have to be aggregated through a business entity's' organisational hierarchy so as to see which business entity is potentially at risk.

This cannot be done easily now as can be seen by the code construction itself, there is no easy way to organise randomly generated codes into a top of the house exposure except by building huge mapping tables with its inherent risk.

Recall that the CFTC declared a "problem" with aggregating data from just three US SDRs earlier this year and called a public meeting of its Technology Advisory Committee in April to address this (see <http://www.cftc.gov/PressRoom/PressReleases/pr6573-13>).

It has now become a global issue as there are 13 facilities operators approved for issuing pre-LEIs and nearly 20 SDRs worldwide. The former is now being dealt with by the ROC and in the later by the FSB, not due for resolution until mid-2014.

The interoperability and data aggregation issue of Sefs (there too is about 20 worldwide) is similarly being dealt with in the US and in the EU by local derivatives regulators in consultation with their constituents. Data aggregation is the mantra, not just the individual labeling of the identification pieces of the transaction, although that is a start.

With all this work yet to be done what is the rush to turn the system on? It might be best to go slow and study what was and what needs to be, then to stand up the component parts in some logical order making sure it is fit for purpose, by itself, and in context of the longer term goal of risk adjusting the financial system.

A building is built one brick at a time, but with an approved master plan. We have started to lay down the bricks without such a plan.

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