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CESR
Committee of European Securities Regulators

Submitted via www.cesr.eu

Consultation Paper *Classification and identification of OTC derivative instruments for the purpose of the exchange of transaction reports amongst CESR Members*

London, September 30th, 2009

Dear Sirs,

Markit welcomes the publication of CESR's Consultation Paper *Classification and identification of OTC derivative instruments for the purpose of the exchange of transaction reports amongst CESR Members* and we appreciate the opportunity to provide you with our views on this topic.

Markit is a financial information services company with over 1,200 employees in Europe, North America, and Asia Pacific. Over 1,500 institutions use our independent services to value financial instruments, manage risk, improve operational efficiency and meet regulatory requirements. Markit provides pricing services for financial products across all asset classes including many instruments that do not actively trade. Some of our pricing services, such as Totem Valuations, have been operating for more than 10 years providing the market with fair value levels in over-the-counter derivatives. Today, all major banks, broker dealers, buy-side institutions, and commodities traders will use Markit's services to assist them in the process of determining the fair value of their positions and in the preparation of their financial accounts.

In addition to our pricing services we have developed extensive experience in creating identifiers for financial products. Markit is the owner of Markit RED, the Reference Entity Database providing the market standard identifiers for credit default swaps (CDS) that are used by most market participants to confirm and process CDS trades. In addition to operating Markit RED for many years we have gained experience in creating identifiers for other asset classes such as commodities or loans.

That said we feel well placed to comment on issues related to identification and classification of OTC derivatives for the purpose of the Trade Reporting Mechanism (TREM). We hope that you will find our comments useful and we would be more than happy to provide additional information or discuss any questions that you might have.

General comments

Based on our experience we are of the view that identifier projects for financial instruments, in order to be successful, need to be managed by an organisation that understands both the needs of the industry and the characteristics of products and markets. Furthermore it should ensure the ongoing and timely maintenance of identifiers and achieve their adoption across the entire industry. This should include regulators and central clearing counterparties (CCPs) in order to maximize efficiency and minimize the cost of implementation.

That said there are a number of issues that need to be considered in the context of identifiers for OTC derivatives specifically:

- Creating identifiers for financial products is all the more complex the less standardised they are. Even if the legal definition of terms for OTC derivatives will often be standardised, based for example on ISDA definitions, the economics of most contracts will differ in many different aspects. It will therefore already prove to be quite challenging to capture the contract details of OTC contracts even in just one asset class in a single identifier. As the differences between asset classes and different OTC products are substantial, we are of the view that CESR's goal of using one single set of identifiers to properly capture the details of most OTC products is probably unrealistic.
- To minimize the burden on market participants and maximize consistency it must be in the interest of all stakeholders to use identifiers that are broadly accepted and used already also for transaction reporting.
- The asset class of CDS has experienced a significant standardization over the last couple of years and now uses fixed coupons and a standardized rolling effective date. CDS are therefore probably one of the few OTC products where an identifier that captures all trade details can be created and we have started expanding our RED identifiers accordingly.

Identifiers for Credit Default Swaps

We do not share CESR's view that any ISIN can be deemed an "underlying obligation" and thus can be used to identify OTC trades, as this was actually one of the primary misconceptions that ultimately led to the development of RED for CDS and its rapid adoption beginning in 2003. For CDS in particular there are a number of reasons why an ISIN will be insufficient as an identifier and why CDS specific identifiers were created:

- It is not unusual that the same obligation is used as a Reference Obligation for a number of different traded Reference Entities for CDS, for example if it was jointly issued by several entities or if it received a guarantee. The use of an ISIN is therefore not sufficient to identify what Reference Entity has actually been traded.
- When bond obligations are transferred from one entity to another the CDS protection might move too, it could still cover the old entity, or it could be split between the old and the new entity, depending on the individual circumstances. Referencing an ISIN in such a situation will not allow any conclusions regarding the fate of the CDS.

- The use of an ISIN will not provide any information about the characteristics of the protection, such as no Restructuring vs. Modified Modified Restructuring, a difference which can be quite relevant in default situations.

While an ISIN therefore seems clearly insufficient to identify a CDS trade, it is worth noting that a widely accepted identifier for CDS exists already. Since 2003, Markit RED codes have established themselves as the standard identifiers for Credit Default Swaps (CDS) and Leveraged Loan Credit Default Swaps (LCDS). Markit RED currently has over 300 subscribers, including the vast majority of active CDS users as well as many market data vendors, technology providers and fund administrators that support the CDS product. Markit RED provides critical reference data to enable the confirmation of credit derivative transactions in a reliable fashion, hereby reducing legal risk and increasing operational efficiency.

To understand why RED was created and what value it creates one should know that to legally confirm a CDS trade the counterparties need to agree on the Reference Entity and a Reference Obligation. Given the complexity of many corporate structures and the multitude of entities that often exist for one “company”, there were a number of instances in the early days of CDS trading where counterparties disagreed about the entity that had been traded, often only noticing years after the original trade date. Furthermore, it was often unclear whether the proposed Reference Obligation had really been issued or guaranteed by the Reference Entity. Finally, there was no central, verified database to document and track corporate events that will cause company names and structures to change with an impact on the CDS protection. Overall this situation was inefficient, created a high degree of legal uncertainty, caused errors, disputes and held back the growth of the CDS market.

The Reference Entity Database (RED) for CDS was created as a joint initiative of some market makers and was subsequently acquired by Markit in 2003. Markit RED legally verifies the relationship between Reference Entities and Reference Obligations which trade in the CDS market, with the linking of a Reference Entity and Reference Obligation known as a pair. The legal verification process is managed by an experienced team working in conjunction with a leading international law firm with extensive experience of derivative products. Reference Entities and pairs are uniquely identified with alpha-numeric RED Codes that are 6 and 9 digits long respectively, and are used to facilitate straight-through processing and ensure accuracy in reference data mapping. The most liquid Reference Obligations are flagged as the market standard “RED preferred” and are utilised as part of the various CDS indices Markit iTraxx and CDX.

As it is not unusual for Reference Entities to experience corporate restructurings, mergers, splits and other events during the life time of the CDS trade, it is crucial to legally confirm what exactly has happened to the company, its debt, and, as a consequence, to its CDS. For that purpose the Markit RED succession event repository has been built to provide automated corporate event alerts and allow users to access a historical database of corporate events.

Markit RED has been fully integrated with most of the major inter-dealer brokers, as well as with trade execution, trade processing and market data platforms that operate in the CDS market. RED codes are used to clean existing data used in credit derivative applications, to facilitate straight through processing and ensure accuracy in reference data mapping. They are therefore widely used for electronic trading, matching and clearing.

Coverage of RED Identifiers

The Markit RED identifiers cover entities, pairs, and indices for regular credit default swaps as well as for LCDS:

- Markit RED Entities holds critical information about the Reference Entities trading in the CDS market, such as the long legal name and the jurisdiction, each identified with a unique 6-character RED code. Since the creation of the RED database more than 10,000 6-digit entity codes have been created for corporate, financial and sovereign entities across more than 100 jurisdictions.
- Markit RED Pairs link frequently used Reference Obligations with their corresponding Reference Entities, with each pair identified by a unique 9-character RED code. Since the creation of the RED database more than 4,800 9-digits RED codes have been created for the relevant obligations.
- Markit RED Indices provides a unique 9-character RED code for each on-the-run and off-the-run Markit CDS index, which links to legally verified index constituent reference data for these indices. Markit RED index codes are used to specify the index name, annex date and effective date on CDS index trades.
- Markit RED has been expanded to support the growth in trading CDS referencing leveraged loans (LCDS) by providing transparent reference data.

Enhanced Identifiers for CDS

With the introduction of quarterly maturity dates, fixed coupons and rolling effective dates, single name CDS contract features have become increasingly standardised over the last couple of years. We have therefore started expanding the existing RED database to develop enhanced CDS identifiers which will incorporate additional standardised features besides the Reference Entity and Reference Obligation.

A simple example could be a CDS contract that is agreed with the following terms:

- Reference Entity = Axa
- Reference Obligation = ISIN XS0130738213
- Seniority = Senior
- Transaction Type = Standard European Corporate
- Trade Currency = EUR
- Coupon Type = Fixed (500 BPS)
- Maturity Date = 20th June 2019

This specific CDS contract would be represented in RED using the enhanced identifier “FF667MAA41121A” where:

- Characters 1-6 (“FF667M”) is the 6-digit RED code representing Axa as the Reference Entity
- Characters 7-9 (“AA4”) represent the Reference Obligation with the ISIN XS0122028904. This bond would also be denoted as senior in the RED database. (Together the Pair or 9 Digit RED code would be “FF667MAA4”)
- Characters 10-14 (“1121A”) represent a unique code identifying the Transaction Type (as defined within the ISDA Credit Derivatives Settlement matrix), Trade Currency, Coupon and standardized Maturity Date.

This extended RED code will provide an instrument code for the specific CDS contract, and as such will accurately describe all key attributes of the underlying contract. The only details that are not captured by the enhanced identifier are specific to the individual trade, i.e. the notional of the trade and its price.

Mapping Services

For a regulatory body tasked with performing market surveillance and monitoring insider trading it will be important to identify activity in all different instruments that reference a specific company. In this context it will be useful to know that we provide cross-asset class mapping of Markit RED identifiers to commonly used identifiers in the cash equities market such as the equity ISIN, where an issuer in the equities market is also traded as a Reference Entity in the CDS market. Also, as Markit progresses with identifiers for other asset classes, such as our recently announced initiative to offer standardised identifiers for entities transacting in the loan market, these identifiers are also expected to be included in this cross-asset class mapping service.

We hope that our comments are of value to you. Please do not hesitate to contact us if you require further information or if you want to discuss any of our comments in more detail.

Kind regards,

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