



Classification and identification of OTC derivative instruments

Introduction

London Market Systems welcomes the opportunity to respond to the call for evidence of the Committee of European Securities Regulators (CESR) on the Classification and identification of OTC derivative instruments (Ref: CESR/09-618).

Having contributed to the FpML/ISDA response and to avoid any duplication, this report focuses on the key instrument classification/identification terms, namely the *Ultimate Underlying ISIN*, *Underlying Instrument type* and *Derivative type* (the “CESR Classification”).

Key Instrument Classification/Identification Terms

The CESR proposal recommends using the following terms to classify and identify a derivative instrument:

1. *Ultimate Underlying ISIN* – this is the ISIN of the ultimate equity or bond instrument underlying the derivative. For example, if the derivative is an option on a future on a share (if exists), this is the ISIN of the share.

The assumption has been made that there is an ISIN allocated for every ultimate underlying instrument. Even if an ISIN exists, some markets do not make use of them, therefore the ability to support an alternative identifier should be considered. Users should also be given the opportunity use an alternative identifier to avoid paying licence fees.

2. *Underlying Instrument type* – this is the type of the immediate underlying instrument.... It is proposed to use the first letter of the CFI code for this purpose.

The first letter of the current CFI is one of the following:

- E = Equities
- D = Debt Instruments
- R = Entitlements (Rights)
- O = Options
- F = Futures
- M = Others (Miscellaneous)

Using the first letter of ISO CFI it is not be possible to identify the type of derivative in every instance. For example, Contract for Difference, Spread bets and OTC derivatives are not supported by the first letter of the CFI. In addition, it is not possible to differentiate Warrants (which are identified by the second letter of the CFI) from Entitlements (Rights). The ISO CFI is unlikely to fully meet the regulators requirements and will need to be extended to support all the possible underlying products. It is also worth reading the section titled, “ISO 10962 CFI – The New Version” as this may affect the decision on the use of the ISO CFI in this context.

3. Derivative type – this is the classification of the OTC derivative instrument defined in this chapter.

Options, O

Warrants, W

Futures, F

Contract for Difference and Total Return Swap D

Spread bets, X

Swaps (other than CfDs, TRS and CDS), S

Credit Default Swap Z

Complex derivatives. K

Though the *Derivative Type* is a reasonable classification, it does not provide one with ability to identify the key characteristics of financial instruments. The grouping of derivative instruments under such broad categories also results in the loss of value to the regulators as products are normally designed to support specific risk scenarios.

Defining a classification that identifies the key characteristics would future proof the reporting mechanism, provide more meaning, and minimise the risks of instruments being incorrectly classified, as some instruments may fall under more than one *Derivative type* category.

ISO 10962 CFI – The New Version

A new version of the ISO CFI under development, which is likely to be approved/officially released in mid 2010, this will result in a number of changes from the current version which CESR will need to consider.

The key changes include:

- The creation of a new structured products category, meaning that the first character of the CFI will be populated with an “S” for these instruments. Currently structured products are classified as either Equity (“E”) or Debt (“D”) depending upon how they are traded. All existing classifications for these instruments will be re-classified.
- A proposal to create a new category to encompass derivative instruments. This “Derivative Contracts” category will be identified by the letter, “C” appearing in the first character of the ISO CFI. The second character will then be used to identify the type of derivative (Call Option, Put Option, Future, etc...). This proposal also includes a definition for “Contracts for Difference”. The impact of this will need to be considered in light of the CESR proposal to use only the first character of the CFI within the *Underlying Instrument type*.

Conclusion

Using the three terms (*Ultimate Underlying*, *Underlying Instrument type* and *derivative type*) to identify the characteristics of derivative instruments should be sufficient to meet the current needs associated with transaction reporting. The assumption being that this is a simple mechanism that reporting parties can easily adhere to. However it is not possible to identify the reasoning behind the use of the financial products, due to the lack of granularity, and given that the ISO CFI does not support all the financial instruments within the scope of MiFID, CESR should therefore consider the creation of a classification scheme capable of supporting all financial instruments.

The creation of an instrument classification scheme to support the needs of the *Underlying Instrument type* is recommended, with a subset of this scheme being used to support the requirements of the *derivative type*.