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CONSULTATION PAPER

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

Deadline for contributions: CESR invites responses to this consultation paper by **1 October 2009**. All contributions should be submitted online via CESR's website under the heading 'Consultations' at www.cesr.eu. All contributions received will be published following the close of the consultation, unless the respondent requests their submission to be confidential.



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Glossary

<i>TREM</i>	The Transaction Reporting Exchange Mechanism that allows CESR members to exchange transaction reports.
<i>MAD</i>	Market Abuse Directive (2003/6/EC), OJ L 96/16 12.4.2003
<i>MiFID</i>	Markets in Financial Instruments Directive (2004/39/EC), OJ L 145, 30.4.2004, p.1.
<i>MiFID Level 2 Regulation</i>	Commission Regulation (EC) No. 1287/2006 of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and the Council as regards record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purpose of that Directive, OJ L 241, 2.9.2006, p.1,
<i>MTF</i>	A Multilateral Trading Facility as defined in Article 4 (15) of MiFID. It is a multilateral system, operated by an investment firm or market operator, which brings together multiple third-parties buying and selling interests in financial instruments.
<i>OTC derivative</i>	A derivative instrument which is traded over-the-counter where the value of the instrument is derived from or otherwise dependent on the value of a debt or equity security instrument or instruments that are admitted to trading on a regulated market.
<i>Regulated market or RM</i>	A Regulated Market as defined in Article 4 (14) of MiFID.
<i>CFI</i>	Classification of Financial Instruments - ISO standard 10962 (6166) The CFI code is a 6 characters code that classifies an instrument. The official CFI code of the instrument can only be allocated by a National Numbering Agency. However, it is authorized to use the standard to generate “unofficial” CFI codes for instruments.
<i>AII</i>	Alternative Instrument Identifier This identifier is used to identify exchange traded derivatives on certain markets where those markets have elected to identify the instruments admitted to trading on their markets using the AII code rather than the ISIN code (see below). The code is composed of six characteristics or data fields of the contract: market code, exchange product code, strike price, expiration date, derivative type, put/call.
<i>ISIN</i>	International Securities Identification Numbers - ISO standard 10962 (6166) The ISIN code is a 12 alphanumeric code that identifies uniquely a single instrument. ISIN codes are allocated, in each country, by a National Numbering Agency (NNA).
<i>NNA</i>	National Numbering Agency The NNA of a country is in charge of allocating CFI and ISIN codes to instruments according to the relevant ISO standards.
<i>ANNA</i>	Association of National Numbering Agency The ANNA is the international body that coordinates the work of the National Numbering Agencies (NNA).



I. Introduction

A. Transaction reporting in Europe

Competent authorities (“CAs”) throughout the European Economic Area are committed to detecting market abuse and maintaining the integrity of their markets. The receipt and examination of transaction reports are essential elements in enabling CAs to detect market abuse and the Market in Financial Instrument Directive (MiFID) gives CAs the power and obligation to collect transaction reports on instruments admitted to trading on regulated markets. However, many CAs have noted that there are a range of OTC (over the counter) financial instruments that mirror instruments admitted to trading on regulated markets that can equally be used for the purposes of market abuse. Many CAs extended the collection of transaction reports to include OTC instruments whose value is derived from instruments admitted to trading on a regulated market to enhance their ability to detect suspicious activity and maintain the integrity of their markets. Some other competent authorities are currently investigating this option as well.

B. The Transaction Reporting Exchange Mechanism

CESR has implemented in November 2007 an IT system to facilitate the exchange of transaction reports amongst regulators. The system, called the Transaction Reporting Exchange Mechanism (TREM), was built based on the request from the MiFID level 2 Regulation to organize the exchange of transaction reports amongst European financial regulators.

TREM is currently limited to the scope of the MIFID Level 2 regulation, e.g. exchange of transaction reports on instruments admitted to trading in Europe. After one and a half year of running and study of the different practices within CESR membership, CESR decided to launch a project to amend TREM to facilitate the exchange of transaction reports on OTC derivative instruments amongst CESR members.

This consultation paper is aimed at defining the framework for this exchange. In this respect, the document focuses only on the identification and classification of OTC derivatives for the exchange within TREM. Even though maximum harmonization is expected amongst CESR members, local specificities might lead to different requirements than the ones described in this document.

C. Scope of Transaction Reporting on OTC derivative instruments

CESR decided that only transactions on derivatives whose underlying instrument is traded on a regulated market should be exchanged, focusing on single-name derivatives, except when different underlying instruments all refer to the same issuer. As for TREM, this excludes non-securities derivatives that have a specific transaction reporting regime.

In line with the above, CESR decided to exchange transactions on the following OTC derivatives:

- Options
- Warrants
- Futures
- Contract for Difference and Total Return Swap
- Spreadbets
- Swaps (except CfDs, TRS and CDS)
- Credit Default Swap
- Complex derivatives

CESR decided to go for a more comprehensive approach where derivatives that would not fall within plain-vanilla general categories would still be reported under a common “complex derivatives” label. The boundaries between “plain-vanilla” and “complex” derivatives will be further defined in



harmonised guidelines, as well as other useful common standards for consistent collection of data between participating Member States.

D. Identification and classification of OTC derivative instruments

To monitor the market, CESR members should have a common understanding of the transaction reports they exchange. It requires a common business language between regulators. To allow CESR members' IT systems to exchange transaction reports, a common exchange protocol is also required. A protocol would ensure that transaction reports collected in a member state would be accepted and processed by the system of another CA.

To achieve the two points above, CESR members should standardize the data they exchange. TREM has already settled standards for transaction reports on instruments admitted to trading on regulated markets. However, there are two fields in which the standards used in TREM do not apply to transaction reports on OTC derivative instruments: classification (derivative type) and identification (instrument identifier).

CESR ran a Call for Evidence in February 2009 to get markets participants' inputs on the identification and classification of OTC derivative instruments. This document results from the study of the answers to the Call for Evidence.

II. Section 1 – Classification of OTC derivatives

According to Annex 1 of the MiFID level 2 regulation, the instrument type is defined as: "The harmonised classification of the financial instrument that is the subject of the transaction. The description must at least indicate whether the instrument belongs to one of the top level categories as provided by a uniform internationally accepted standard for financial instrument classification."

The OTC derivative instruments are permanently evolving. The number of instruments types is unlimited as a derivative contract can contain anything that the parties agree on. It means that three points should be taken into consideration while defining a classification of OTC derivatives:

- This should be a high level classification, knowing that there are many sub-classes under an instrument type,
- The classification has to be reviewed frequently as the market changes quickly,
- There are a number of unclassified instruments that are too complex to be classified.

For the purpose of transaction reporting, the goal is to identify the most frequently used instruments types and obtain the corresponding transaction reports. The classification should evolve at the same rhythm as the market usages to ensure the best coverage of transaction reporting.

E. The Classification for Financial Instruments (CFI) – ISO Standard 10962

In TREM, the instruments are classified using the ISO 10962 (CFI) standard. An analysis of this standard has been conducted by CESR to identify the codes that would be required to classify the instrument types defined in paragraph I.C above. Only two (2) out of the eight (8) types of instruments are currently covered by the CFI code (options and futures).

CESR is aware that the ANNA is currently working on a new version of the standard. It expects to issue the new version by the end of 2009 at the earliest, date at which its implementation would start. The new version of the CFI code is expected to cover the new instruments types requested for transaction reporting.

The CFI code is composed of 6 letters which represent six different characteristics of the instrument. For simplification purposes, only the first letter is currently mandatory in TREM. However, to



differentiate the types of OTC derivatives above, it is expected that the first letter will not be sufficient and eventually six letters would be required to classify the OTC derivative instruments to the level of granularity required by regulators.

Given the essence of the OTC derivatives, CESR thinks that it would be too burdensome for the investment firms creating an OTC derivative to require a National Numbering Agency to create a CFI code for each contract. Therefore, the only option left would be to ask the investment firms to generate the code based on the standard.

CESR concluded that requiring the investment firms to fill in the six letters of the CFI code would be a major burden and the costs implied would be greater than the benefit for the regulators. Implementing the full CFI code is too complex to implement for market participants solely for the purpose of transaction reporting.

F. FpML

FpML® (Financial products Markup Language) is the industry-standard protocol for complex financial products. It is based on XML (eXtensible Markup Language), the standard meta-language for describing data shared between applications. FpML is developed by the ISDA (International Swaps and Derivative Association).

FpML is a number of schemas containing data set to describe financial instruments. FpML has developed six schemas to date to describe the following six types of instruments:

- **IRD:** Interest Swaps, Swaptions, FRA's, Caps and Floors, Inflation Swaps, and Bullet Payments.
- **FX:** Foreign Exchange Swaps, Spots, Forwards, and FX Options.
- **Credit:** Single-name Credit Default Swaps, Loan Credit Default Swap, CDS on Mortgages, Credit Default Swap Indices, Options, and Baskets.
- **Equity:** Equity Swaps, Equity Options, Variance Swaps, Correlation Swaps, Dividend Swaps, and Total Return Swaps.
- **Bond Options:** Bond and Convertible Bond Options.
- **Commodity:** Commodity underlying, Commodity Swaps, Commodity Options.

Unfortunately, using this classification without using the full FpML to describe in each class the characteristic of the instrument would not be adequate to the requirement of market monitoring and understanding the position that the derivative gives on the underlying.

Therefore, CESR thinks that this classification, without using the full FpML system, does not fit to the needs of market surveillance by CESR members.

G. CESR classification

The CFI code and FpML being the only open and free standards for classification of financial instruments proposed by the Call for Evidence, the remaining solution is that **CESR defines a simple classification system for the purpose of transaction reporting of these instruments based on the classification currently used by the UK FSA and Irish FSRA.**

As stated in I.C, CESR decided that the classification system should allow differentiating the following elements:

- Options
- Warrants
- Futures
- Contract for Difference and Total Return Swap
- Spreadbets
- Swaps (except CfDs, TRS and CDS)



- Credit Default Swap
- Complex derivatives

This system allocates one letter for each type above. Using this classification would ensure that the costs for regulators as well as the industry already using this classification would be minimal. It would use an “already in place” system that is currently being run.

The classification also has the great advantage of simplicity (one letter) to maintain and to implement, which is an important consideration to help ensure quality of data. It would also ensure a flexible system for regulators in the future.

The group decided to use a single letter for each class:

- | | |
|---|---|
| • 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 |

Some regulators might request different letters locally for the letters above for reporting.

Question 1: Do you agree with CESR’s proposal? Any comments on CESR’s view on this subject?

III. Section 2 - Identification of OTC derivative instruments

According to the Annex 1 of the MiFID level 2 Regulation, the instrument identifier is defined as: “— a unique code, to be decided by the competent authority (if any) to which the report is made identifying the financial instrument which is the subject of the transaction, — if the financial instrument in question does not have a unique identification code, the report must include the name of the instrument or, in the case of a derivative contract, the characteristics of the contract.”

H. ISIN – ISO 6166

In TREM, instruments are identified using the ISO 6166 (ISIN) standard or the Alternative Instrument Identifier (AII) for some derivative markets. The ISIN standard does not currently cover OTC derivative instruments.

The Alternative Instrument Identifier was implemented due to the costs that it would incur to the industry to apply ISIN codes to all derivative instruments. Therefore, CESR considers that mandating all market participants to allocate ISIN codes to all OTC derivative instruments would be an extremely costly and burdensome request. CESR concludes that using ISIN codes for the identification of all OTC derivative instruments is not appropriate.

I. The Alternative Instrument Identifier (AII)

The AII code is comprised of a set of characteristics of the contract admitted to trading including the market of admittance and the exchange product code. As these two fields are the core of the AII and also do not apply to OTC products, the current version of the AII code would not be usable for OTC derivative instruments.

Therefore, neither the ISIN nor the AII codes currently apply to OTC derivative instruments.



CESR considered also building an identifier based on the AII codification. This would mean using a set of characteristics to create a pseudo-AII for OTC derivative instruments. The following paragraphs express the thinking of CESR regarding the usage of a set of product characteristics.

One of the conclusions is that six characteristics are too few to identify correctly an OTC derivative instrument. CESR therefore proposes to use a set of seven characteristics to allow CESR members to understand correctly the instrument traded.

J. Set of characteristics of the contract

To build a system similar to the AII, CESR considered using **a number of characteristics of the contracts** as stated in the MiFID level 2 Regulation. Given the fact that an OTC contract can contain an unlimited number of characteristics, a definite set of characteristics would not identify uniquely each instrument.

Relationship between the transaction and the OTC derivative instrument

An OTC derivative instrument is a contract between two investment firms. Such a type of contract is not fungible except if stated in the contract itself. Some market operators provide facilities to change the owners of a contract, but it is not clear whether legally this should be considered as the same contract or a new one.

Given the limited fungibility of these instruments, it is today considered by regulators that each transaction corresponds to one contract. Therefore, the need for having a unique identifier does not seem to exist as the transaction reports are already identified uniquely.

Market surveillance requirements

The main goal of monitoring the market of OTC derivative instruments is to watch positions on instruments admitted to trading on the regulated markets. The market surveillance is more interested in the position on the underlying instrument than the contract itself.

A unique identifier for financial instruments might be useful for two reasons:

- If the instrument is fungible, to follow the chain of transaction reports and the people who have owned the instrument over time.
- For automatic processing of transaction reports, to group the transaction reports by financial instrument and analyse the set of transaction reports related to a particular underlying instrument.

Due to the very limited fungibility of the OTC derivative instruments, the first point described above is very limited in this context. The change of owner of an OTC derivative is so seldom that it would not be relevant from a Market Surveillance perspective.

Regarding the second point, the objective of transaction reporting on the OTC derivative instruments is to watch the positions or exposure in the underlying instruments. The automatic processing of the transaction reports on these instruments will therefore concentrate on grouping the transaction reports per underlying instrument and per type of position (short or long) rather than per OTC instrument.

For example, the Market Surveillance of a given CA would implement a systematic alert detecting if a specific entity (investment firm or client) has bought a number of OTC derivatives that would give him an abnormal position on a specific share.

CESR concludes that its objectives would be fulfilled with a set of characteristics ensuring a clear view on the position taken on the underlying. Building a unique identifier would be extremely



difficult and less useful for market supervision. Therefore, CESR decides that no identifier would be used for these instruments for the purpose of market abuse detection via transaction reporting, only a set of characteristics to describe the main elements of the instrument would be required.

CESR proposes to add to the usual fields exchanged in TREM the following elements:

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.
2. Underlying Instrument type – this is the type of the immediate underlying instrument. On the example above, this would be “future”. It is proposed to use the first letter of the CFI code for this purpose.
3. Derivative type – this is the classification of the OTC derivative instrument defined in this chapter. In the example above, this would be an option.
4. Put/call identifier – in case of an option.
5. Price multiplier.
6. Strike Price.
7. Expiration date.

The set of field above would not be an identifier as such, but a set of fields describing the main elements of the contract.

In addition to the mandatory fields above, TREM will accept the ISIN code of the OTC derivative instrument if provided on a voluntary basis by the investment firm. The provision of this code would not be mandatory. However, it would be useful for future filing to have the possibility in TREM to readily exchange this code.

Question 2: **Do you agree with CESR’s proposal ? Any comments on CESR’s view on the above?**