The Legal Entity Identifier: *what it is, when it's due, and what it means*

The Legal Entity Identifier (LEI) is a global programme designed to create and assign unique identifiers to any financial organisation that engages in a transaction. LEIs meet many needs. Regulators need LEIs to better gauge systemic risk, and risk managers need LEIs to better aggregate counterparty exposures. This article explores LEIs, their history and the business need, while identifying the key players – now and in the future.

Mark Davies is a Vice President at The Depository Trust & Clearing Corporation (DTCC), New York, USA.

It is really a simple concept but it meets a number of needs – assign every legal entity engaged in financial transactions a unique identifier and immediately firms will be able to more efficiently track counterparties to trades, streamline processing capabilities and improve risk management. While financial institutions have long employed internal and public identifiers for these purposes, the lack of a uniform global standard has limited the value of this reference data to enhance market transparency and mitigate systemic risk.

Following the 2008 financial crisis, regulators and industry participants have come to agree on the need to develop a global solution that allows transactions to be tracked across financial markets and multiple jurisdictions. Now that there is widespread support for creating a uniform legal entity identifier (LEI), policymakers are engaged with stakeholders globally to address the challenges and potential obstacles of transforming this concept into reality.

NEED FOR STANDARDISATION

To better understand the present myriad challenges and opportunities surrounding LEI creation, knowing the past is a must. Large financial institutions tend to have multiple legal entities within their corporate structure, with some global organisations operating as many as 4,000 distinct subsidiaries. As they have grown, these organisations have become increasingly complex, making it difficult for regulators and risk professionals to fully understand market exposures to any one group of companies.

There is a long-standing industry requirement that financial firms know their counterparties. To do so, most firms have developed their own proprietary numbering systems. In larger firms, it is common for each division or trading desk to use their own system- or division-specific numbering systems. As a result, multiple numbers are used within one institution to identify the same entity.

Data, infrastructure and rating vendors will issue their own numbering schemes to identify companies within their products. Many regulators and central banks also insist on reporting with the use of their own independent company numbering schemes. The result is a huge number of identifiers that are relevant for different segments of the global financial market, with different use restrictions and quality standards.

The segments and data supporting the identifiers constantly change as new codes are issued and companies come and go. This has developed into a substantial and costly overhead for firms to effectively manage these codes for operational processing and financial reporting. A single view of each entity remains essential to many functions, none more so than for risk professionals to consolidate, track and manage exposure and to be able to react quickly and effectively to market crises.

IDENTIFYING A SOLUTION

Aware that a new approach and 'common language' were needed in the wake of the 2008 financial crisis, the USA took a first step in addressing the situation, creating through the Dodd-Frank Act the Office of Financial Research (OFR). Realising the need to start obtaining 'business card' reference data such as the entity's legal name, address, jurisdiction, any prior names and, if available, ultimate parent organisation, the OFR promoted the establishment of a universal LEI and called for a solution backed by international consensus.

In March 2011, the International Organization for Standardization (ISO) created a working group to draft standards for a global LEI programme. A number of financial industry trade groups in the Americas, Europe and Asia then defined business requirements for a global LEI solution and invited providers to bid to develop and manage the solution.

In response, ISO, the Depository Trust & Clearing Corporation (DTCC) and SWIFT submitted a joint proposal. DTCC and SWIFT were selected to serve as facilities manager and issuing authority for the industry's solution, in conjunction with ISO as the approved standard body and the Association of National Numbering Agencies (ANNA) as partners for federation to local markets.

At about the same time, the G20 mandated the Financial Stability Board (FSB) to deliver recommendations on the LEI system. DTCC and SWIFT continued to develop a system to assign LEIs and store and validate the accuracy of the associated reference data. The need was to develop a consistent and scalable methodology for these tasks and to recognise that regulators needed optimal transparency in this data to begin addressing systemic risk issues.

The Legal Entity Identifier: *what it is, when it's due, and what it means*

USA MOVES FIRST WITH CREATION OF CICI

The US Commodity Futures Trading Commission (CFTC) realised that an interim solution had to be in place to meet deadlines set by Dodd-Frank. In March 2012, the Commission put out a request for submissions to establish a CFTC Interim Compliant Identifier (CICI). Identical in structure to the LEI, the CICI would provide identifiers for firms who traded in over-the-counter (OTC) derivatives.

"The need was to develop a consistent and scalable methodology for these tasks and to recognise that regulators needed optimal transparency in this data to begin addressing systemic risk issues."

As the interim solution was developed, the FSB continued to work on its recommendations for structuring a global LEI programme. In July 2012, the FSB endorsed an ISO standard for a 20-character 'non-intelligent' identifier with associated 'business card' data. The FSB also recommended a federated model, which meant that rather than a central body issuing and managing all LEIs globally, the system should support issuance of LEIs and maintenance of the data in local markets.

The FSB called for a Regulatory Operating Committee (ROC) to govern the LEI system, a Central Operating Unit (COU) to coordinate, set and enforce technical standards for each Local Operating Unit (LOUs) and connect the local systems and LOUs, to issue LEIs and validate information. In parallel with FSB's guidance, the CFTC announced their selection regarding the issuance of CICIs in July. The CFTC selected the industry solution already implemented by DTCC and SWIFT, based on the ISO 17442 LEI Standard.

In August, DTCC and SWIFT launched the CICI website, www.ciciutility.org. More than 24,000 legal entities were preloaded into the database and validated by their personnel against publically available authoritative sources. Three months later, more than 11,000 additional legal entities had been added to the database, with roughly 2,000 new legal entities continuing to be registered each month.

INTERIM SOLUTION

DTCC and SWIFT continue to work with the FSB, CFTC and many other global regulators in the FSB's Private Sector Participatory Group to gain consensus on the design and implementation of a universal LEI solution.

In the meantime, the assignment of CICIs is a key step forward in managing risk in the OTC derivatives markets. CICI addresses the immediate need for consistent counterparty identification in transaction reporting for this complex global asset class.

HOW CICI ALIGNS WITH G20 MANDATE

The CICI can be easily and seamlessly adapted to regulatory developments as the FSB model evolves. As an early adopter of the LEI, DTCC and SWIFT have worked closely with the global financial services industry to develop a viable solution that allows for registration, validation and publication of entity reference data across the globe.

DTCC and SWIFT provide entities with a unique 20-character alphanumeric code that is based on the new ISO 17442 LEI standard. Currently, more than 35,000 entities are registered in the CICI database to entities from 114 countries (see Figure 1).

The CICI is designed to be flexible. Since implementation, it has evolved to support federated registration and validation for local market partners, both of which are in line with the shared goals of the industry and the FSB. Recent FSB guidance calls for the use of a structured number scheme for LEIs. As a result, DTCC and SWIFT are the first pre-LOU system to be assigned a four-character prefix and numbers are being issued using the new approach.

With DTCC and SWIFT as industry-owned and governed utilities, the CICI maintains global operations. It is not designed solely for the US market or OTC derivatives – CICI was specifically architected to support all asset classes and jurisdictions to provide an LEI wherever needed.

LOOKING AHEAD: NEXT STEPS FOR INDUSTRY

Developing a standardised method to identify financial parties to a transaction is instrumental in improving transparency, efficiency and risk mitigation in the global marketplace. With an interim solution now in place, what are the next steps?

The FSB recently published a charter for the ROC and invited global regulators to sign up. The ROC will convene in 2013 and focus initially on the key steps to start up a foundation and board for the COU by 31 March 2013. The ROC and COU will then begin setting up the network, technical specifications and requirements for LOUs.

What should firms be doing? The answer to that depends on what and where funds are invested. If a firm trades OTC derivatives with any organisation that is a major swap dealer or major swap participants regulated by the CFTC, the answer is simple: apply for a CICI.

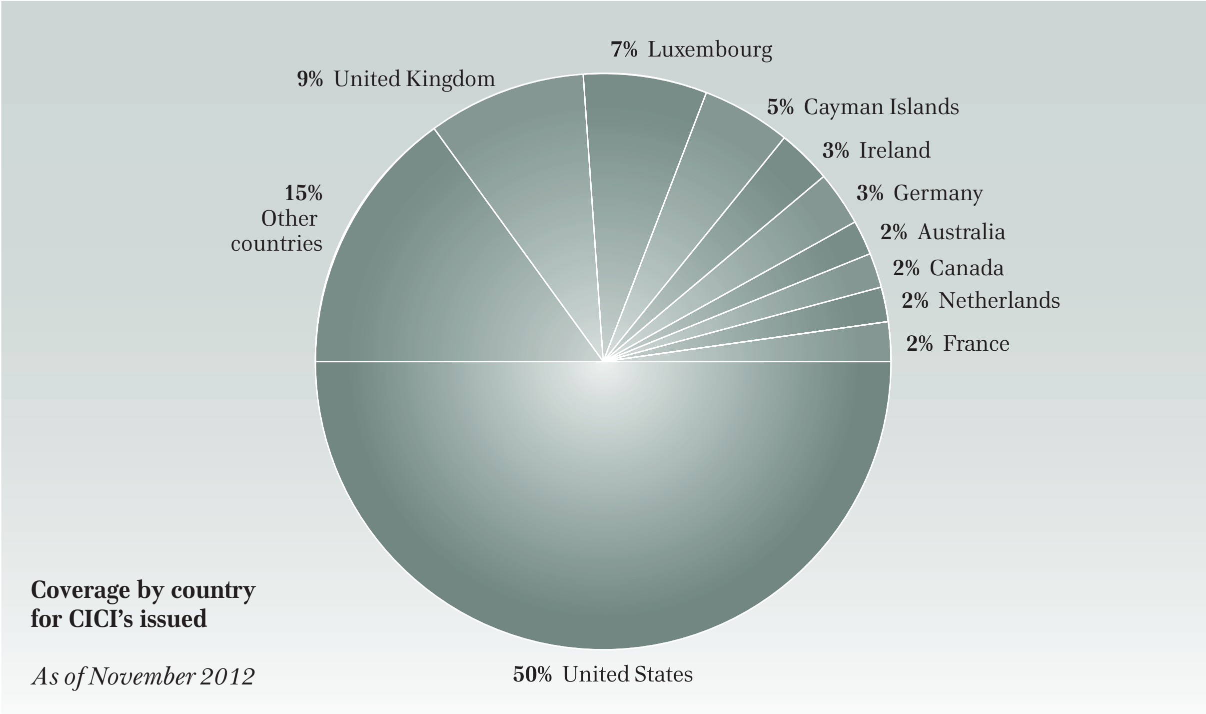

Figure 1. Coverage by country for CICIs issued. Source: DTCC.

Any major swap dealer or major swap participants will need to provide a CICI for themselves and for their counterparties when reporting their trades to a swap data repository. The deadline for swap dealers and major swap participants to begin reporting trades with CICI is 31 December 2012 for credit and interest rate swaps, and no later than 10 January 2013 for commodities, foreign exchange and equity derivatives. All other traders in swaps will need to begin reporting trades by 10 April 2013.

For Europe, it is expected that the European Securities and Markets Authority (ESMA) will require reporting using an LEI in mid-2013. It is possible ESMA will require use of an interim system, potentially based on ISO 17442, before the full global LEI solution is operational.

The next step for firms is to prepare their systems to accept LEI or CICI, and the associated reference data. While this may require reprogramming of multiple systems, it is prudent to incorporate mapping to regulatory reporting applications, as identifiers are likely to be required for all regulatory reporting in the future for any trading.

LEI – A CONCEPT THAT IS LONG OVERDUE

The establishment of a standard tagging method to identify counterparties will help regulators and market participants better aggregate risk and exposures on a global scale, thus enabling systemic risk analysis.

While the G20 has endorsed an international identifier, it will take time, money and effort to establish and implement the necessary plans across all jurisdictions and asset classes. However, given the current challenges that the industry and regulators have encountered, few would argue that this concept is already long overdue.

Mark Davies is a Vice President at The Depository Trust & Clearing Corporation (DTCC). He joined DTCC in January 2012 to help develop the global LEI solution, focusing on LEI outreach within Europe and development of the CICI Utility platform. He also participates in the FSB Industry advisory group for LEI. Prior to joining DTCC, Mark Davies worked at The Royal Bank of Scotland, managing data for Group Risk and the legal entity data solution. In this position, he also served as an active industry participant in the growing LEI debate and was a member of GFMA's global LEI steering committee. Mark Davies earned a bachelor's degree with honours in Business Administration from the University of Leicester.

The Depository Trust & Clearing Corporation (DTCC)

DTCC, through its subsidiaries, provides clearance, settlement and information services for equities, corporate and municipal bonds, government and mortgage-backed securities, money market instruments and over-the-counter derivatives. In addition, DTCC is a leading processor of mutual funds and insurance transactions, linking funds and carriers with their distribution networks. DTCC's depository provides custody and asset servicing for more than 3.6 million securities issues from the USA and 121 other countries and territories, valued at US$36.5 trillion. In 2010, DTCC settled nearly US$1.66 quadrillion in securities transactions. More information at www.dtcc.com.

"Developing a standardised method to identify financial parties to a transaction is instrumental in improving transparency, efficiency and risk mitigation in the global marketplace."