

# LEI

## The 4G of transparent market data

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### Introduction

When the G20 met in Pittsburgh in the wake of the financial crisis, the focus was on remediation. To counter the shocks that the system had suffered, a mechanism was to be put in place to monitor counterparty risk exposure. It had come as a shock to many, including (one suspects) regulators, that the extent of the potential problem was not identified before it emerged as a series of domino-like failures. In that rather sobering environment, it is not surprising that there emerged a firm desire and commitment to ensure that such a situation should never arise again and that transparency should be brought to the markets.

Much of the groundwork had been laid in earlier summits; indeed, when one reads the Pittsburgh communiqué with the benefit of hindsight it is clear that in the collective minds of the G20, the focus had already switched from design to implementation. As a whole, the measures foreseen by the G20 articulate well into a coherent and comprehensive framework.

They create transparency and traceability through a hierarchy of identification, and implement practical measures for each subject to use that transparency for practical purposes. In practical terms, the G20 agreed on the principles and then left the trading 'blocs' concerned, the USA and the EU being those amongst the first to act, to determine and enact legislation allowing the detailed requirements to be implemented.

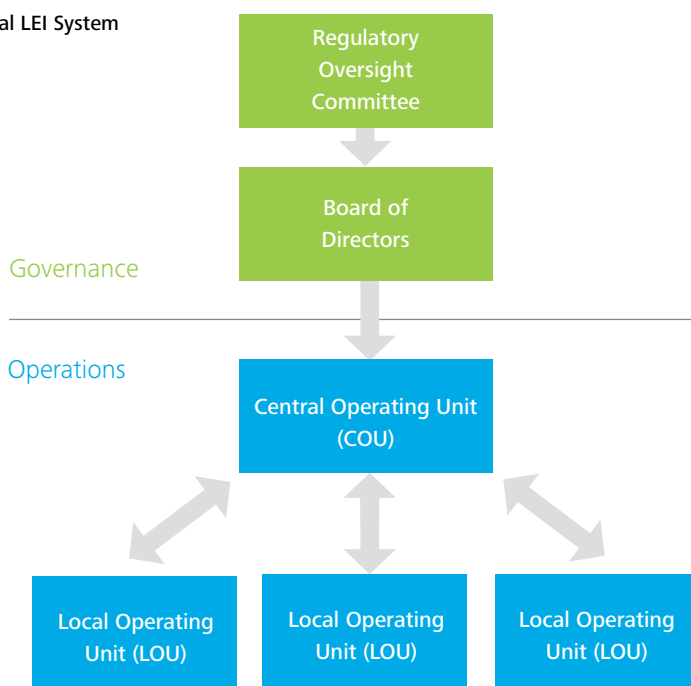
The G20 mandated the Financial Stability Board (FSB) to work on the long-standing industry need for a unique, global and standard Legal Entity Identifier (LEI – the cornerstone of traceability), in order to help assess systemic risk and aggregate risk at an entity level. The FSB set up the ROC (Regulatory Oversight Committee)<sup>1</sup> and defined the format for a standard LEI and a global, federated approach to distributing LEIs.

The idea was a brilliant one. A system to identify market participants and their trades would be created to ensure that at all times the interlocking and overlapping exposures would be clear for all, including competent authorities which could then monitor and if necessary take action to ensure market stability.

<sup>1</sup> Open to all states and state sponsored entities with a view to establishing a global and unique framework to attribute identifiers to all market participants.



**Global LEI System**



- International financial market regulator
- Upholds governance principles and oversees that global - LEI system functions in the public interest
- Plenary and Executive Committee

- Oversees functioning of the COU, operational integrity and implementation, maintenance of standards specified by the ROC
- Appointed and overseen by ROC, composed of stakeholders from financial and non-financial firms

- Ensure application of uniform operational standards and protocols to maintain unique LEIs and high data quality
- Manage federation through LOUs
- Maintain central logical database

- Provision of LEI functions
- Service providers, local business registries, numbering agencies

Within the initial documents setting out the competence and purpose of the ROC was the basic framework the ROC was required to establish and oversee: a governance structure which itself would be supported by a Central Operating Unit (COU) into which would feed national or local operating units

#### Legal versus operational identifier

Unfortunately, the processes were not clearly articulated, or rather the all-important interaction between interlocking initiatives was left almost to chance. Pittsburgh threw together a number of considerations and ideas, not all of them necessarily aligned or thought through to their logical conclusion and not necessarily all grounded in fact. From the outset, the project was heavily weighted towards the banking industry, less so towards corporate and not at all towards investment funds or other market participants. Considerations for the latter and the impacts that certain requirements might have on them only emerged later on the learning curve on which all those involved embarked.

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The financial crisis has brought Data Quality Standards back under the spotlight. With EMIR support, the LEI is expected to be the first piece of this data review puzzle

In parallel to the construction of the governance structure for LEIs, legislation was being drafted that would use the LEI for practical purposes. The first manifestations of this being EMIR in Europe and the equivalent derivative clauses of Dodd Frank. The goal of EMIR and Dodd-Frank is to be able to tell and understand who is holding what exposure to any particular financial sector, instrument or counterparty. This process starts with the LEI and then extends outwards to the use of unique product and transactional identifiers—the UTIs, UPIs and USIs, among others, of which one now hears so much.

The very name given to the future identifier – the Legal Entity Identifier – gives rise for concern. Depending on how broadly or narrowly it is defined, it could disenfranchise entities completely by not considering them as eligible for an identifier if they have no specific legal status (the case strictly speaking for contractual funds and certainly for co-management or pooling arrangements). In many ways it is unfortunate that the word 'legal' found its way into the requirement; it may have seemed logical and self-evident from the point of view of the FSB and the G20, but has inevitably resulted in a lot of reflection and unhelpful complications when it has come down to concretely attributing identifiers to entities that were already considered by markets as bona fide counterparties. The problem centred on the fact that the definition debate was taking place at several different levels of granularity and at different points on the implementation timeline.

### The implementation process

The intended structures of the ROC and infrastructure to support the LEI are clear, but they have yet to be put in place. The ROC is in the process of empowering the formal Board and its governance remit, there is no COU (Central Operating Unit) as yet and those LOUs that have been recognised are still in the process of migrating from 'pre-LOU' to 'full LOU' status. For every acronym associated with the process there is a 'pre' stage, meaning there are 'pre-LOUs', 'pre-LEIs', etc.

This was a time pressure-motivated development, as financial markets could not wait for the ROC to design its perfect model and yet at the same time were dependent on the ROC's blessing of grassroots initiatives for them to mature into workable solutions.

It has been up to the market to put together workable solutions within very basic parameters. This is particularly the case for designing the means of recording and registering transactions themselves. There may yet be problems of divergence in the implementation of the measures using the LEI, and even of the LEI itself.

One not insignificant matter may concern the COU—the Central Operating Unit. It is perhaps regrettable that this key function has been left almost to last in the evolution of the LEI system; regrettable, but almost inevitable. Had the process been given the time to mature from ROC down to LOU before a single LEI was issued, not only would a significant time delay have increased the risk of interim measures being introduced to facilitate EMIR and Dodd Frank alike, but moreover, the lessons learnt along the way in the ad hoc process would have had to be learnt once everything was set up.

The probability that intent and practice would be incompatible in those circumstances would have been increased exponentially. However exactly what the role of the COU should be is still a matter of muted but crucial debate. Should it be, as some would see it, a facilitator promoting bilateral links between LOUs, potentially playing the role of arbitrator should the need arise?



Or should its function be a controlling one, as those more familiar with planned economies – or rather economies that hanker for a high degree of central planning and intervention – might prefer? And should the primary communication channels be between LOUs with the COU as a central co-ordinating and information centre, or should all communication pass from LOUs to the COU for onward transmission? These may be minor points, but they could be crucial in determining how smoothly the system works over time.

On a more practical level, there is divergence of approach regarding one sided or mutual reporting. The United States is happy with a system whereby one counterparty reports on behalf of both and is generally dealer driven.

Europe has opted for a mutual reporting approach, with each party responsible for reporting its own transactions and having the possibility to delegate the function itself but not the responsibility to a third party.

At first glance, mutual reporting may suggest a higher degree of safety (and this is probably central to the European thought process), but there are certainly arguments for and against both approaches.

Notwithstanding all these considerations, pitfalls and difficulties, a system is emerging. The framework of the LEI is there at least and markets are responding to the challenges of creating legislation-specific identifiers to forge the link between LEI and transaction-level reporting.

#### DFA versus EMIR approach

The most disquieting divergence that appears when one examines the detailed comparative requirements of EMIR and the equivalent provisions of Dodd Frank is one of approach. It is clear that Dodd Frank is looking to transparency as a means of ensuring that the market operates efficiently and smoothly, with an emphasis on speed and full reporting to allow the market to converge on pricing and standardisation. The EMIR approach (with its delayed reporting and more extensive data requirements), crossed with AIFMD reporting, appears to focus more on market abuse and its prevention. It will be interesting to see how these objectives play out over time; in the short term they will present particular challenges for those operating cross-border and across regulations.

**An additional twist to consider: AIFMD\***

In isolation, ESMA's decision to use the concept of the LEI to drive AIFMD reporting requirements is logically impeccable. It is clearly within the intent of the FSB and other bodies to work towards a global system of identifiers, and indeed had a decision been taken to use anything other than LEIs it might have been felt that the validity of the whole concept was being called into question.

However, where this introduces an extra level of complexity rather than smoothing the path to coherence is that, beyond the narrow confines of EMIR and the equivalent OTC-related tenets of Dodd-Frank, little concrete progress has been made on the broader framework of the LEI and certainly not with respect to definition. In addition, in invoking the 'LEI' in this context ESMA gives no more than minimal guidance as to how this requirement fits into the overall LEI initiative.

As already discussed, major practical progress has only been made concerning the allocation of de facto pre-LEIs by pre-LOUs in the hope that these initiatives will be approved and validated by the ROC. Clearly, as these initiatives were driven by the immediacy of first U.S. and now European OTC derivative reporting, the focus has been on that sector of the market. There has also been some reflection as to the applicability of 'counterparty' rather than purely 'Legal' (entity identifiers) to accommodate contractual funds, limited partnerships, etc.

The result is that AIFMs and AIFs (entities that have no contact with or activity in derivatives markets of any sort), notably private equity and real estate managers, will be required to contact LOUs set up specifically with EMIR or Dodd Frank in mind to obtain an identifier in the coming months. The lack of familiarity on both sides of the process will be another learning curve on which the broader industry must embark.

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To counter the shocks that the system had suffered, a mechanism was to be put in place to monitor counterparty risk exposure



Beyond the immediate information and operational considerations behind this process, the potential use to which data stored under LEIs will eventually be put should be kept in mind. EMIR and Dodd Frank aim at bottom-up transparency, building a picture of counterparty exposure from the level of the transaction itself (albeit with a top-down hierarchy of identifiers). AIFMD is looking to aggregate transparency at Manager (AIFM) level.

It is unlikely that analysis of data sourced using the two approaches will provide a coherent picture from the outset, especially as the common point of reference – the LEI – is not exclusive. Not all transactions reported under EMIR will be related to an AIFM, far from it. Nor will it be possible to determine which transactions have been aggregated from the LEI alone as used under AIFMD. Without doubt, reporting and coherence will require additional work before truly usable data emerges. Hopefully regulators will not jump to hasty conclusions in interpreting apparent patterns.

#### The way forward for phased quality improvement

In a changing regulatory landscape, organisations need to take immediate steps to assess the impact on their risk and regulatory reporting processes. When adopting the LEI, organisations will have to ask themselves a number of questions:

- Which parts of the business are most affected by LEI? (starting with client on-boarding, data management, regulatory reporting and risk management processes)
- Which business processes could be affected and what are the costs and benefits of LEI adoption?
- What are the secondary impacts of LEI adoption in one process but not the other?

In addition, these key elements of an LEI adoption programme should include the assessment of current (regulatory) initiatives affected by LEI (particularly in the risk management function) and analysis of systems holding client and counterparty data.

In the context of BAU integration, it will also be essential to develop processes to update, match and streamline existing data, while incorporating the LEI.

The LEI clearly entails significant business process, but also implies technology changes across all business lines. Organisations will need to understand what being 'compliant' means for them and determine their approach for achieving such compliance. Using a phased approach, market participants will need to prioritise and execute significant change activities (across data, technology, process and organisation) in line with their agreed strategy, whilst maintaining BAU.



### Conclusion

The LEI is complex and challenging. Its implementation is made all the more challenging by the stop-start way in which EMIR reporting has been a dependency of other elements (authorisation of Trade Repositories etc.). There are risks and issues ahead as the market works through the supporting elements and regulators work on the conundrum of understanding the picture that the data they receive really represents.

#### But the process also offers opportunities

The use of the LEI will undoubtedly improve the ability of supervisors to monitor systemic risk. Moreover, it is a tool to improve risk management within organisations. Organisations with a consistent and accurate group-wide view of their clients and counterparties could improve risk management and their sales and take-on processes, strengthen finance processes and reduce the operational costs associated with downstream impacts of inconsistent and inaccurate data. However, existing data stores (operational, accounting and risk infrastructures) will first need enhancement to integrate the LEI.

The financial crisis has brought Data Quality Standards back under the spotlight. With EMIR support, the LEI is expected to be the first piece of this data review puzzle. Embedding the LEI in product and front line systems presents an opportunity to secure greater straight through processing (STP), to reduce operational costs and the need for reconciliation between data sets that are similar but different (owing to data quality and consistency improvements). Organisations that embrace this opportunity will become more agile and ready for more proactive management of their activities and counterparties.

Above all, it is essential that all concerned take a step back to consider the long-term impacts of the LEI and the big picture to which it has been introduced. Many decisions are being taken to meet immediate reporting obligations; it would be a lost opportunity if those decisions, taken in haste, were not revisited and were allowed to obscure the advantages that enhanced market transparency has to offer.

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