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Frequently Asked Questions

# Derivatives Processing Standards

for credit derivatives

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**Derivatives operations and processing standards** continue to be key issues in the financial markets today. On March 27, 2008, the Operations Management Group (OMG) and the industry's three primary trade associations, ISDA, MFA and SIFMA issued a letter to the NY Federal Reserve Bank that commits to supporting minimum operating standards for credit derivatives market participants. These market participants include asset managers, hedge funds and dealers.

ISDA, MFA and SIFMA worked together and with their respective constituents to develop an industry implementation plan for achieving these minimum operating standards, which was issued to the Fed and other supervisors on June 9, 2008. Copies of the March 27th and June 9th letters are available on the websites of the three trade associations. These Frequently Asked Questions (FAQ) explain the industry's derivatives processing standards and provide information about the role of the Trade Information Warehouse, service providers and the new electronic novation requirements.

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## General Questions

### 1. What are the minimum processing standards for credit derivatives?

Industry participants should use electronic confirmation services for all eligible credit derivatives trades and match as many trades as possible on trade date, with the remainder submitted by T+1. By July 2008, participants should submit 90% of eligible trades to DTCC Deriv/SERV or MarkitWire by T+1. These trades should be submitted accurately, with 90% of trades matched (directly or through a service provider) without amendment.

- A majority of the trades should be matched on T+0 with the goal of 92% of the trades matched by T+5.
- Standard identifiers (RED codes) should be submitted accurately for Reference Entities and Reference Obligations. RED subscribers should submit RED codes accurately on 100% of index trades and 90% of single name trades.
- All allocations should be provided on T+0.
- Novation consent requests should be processed through electronic platforms rather than via email by the end of 2008.

ISDA, MFA and SIFMA have published a one-page document that summarizes the industry goals. (Please see appendix).

### 2. What do these commitments mean for entities that are not regulated by the Fed?

Although the commitments in the letter do not constitute formal regulation, the commitments are an important form of self-regulation and were developed in response to specific regulatory demands to improve market structure. In addition, complying with these commitments constitutes sound business practices and will further enhance operational processing within the OTC market.

### 3. What steps do firms need to take now to meet these standards?

Firms can meet these standards only by using electronic confirmation services such as DTCC Deriv/SERV or MarkitWire (formerly known as SwapsWire) to confirm credit derivative trades. Markit and other service providers such as T-Zero and Tradeweb provide affirmation services that allow clients to link their order management systems to these confirmation platforms.

### 4. What is the DTCC Trade Information Warehouse?

The Trade Information Warehouse (TIW) is a centralized and secure global infrastructure for processing OTC derivatives throughout their lifecycle, which could extend for years. It consists of two components:

- A comprehensive trade database containing the primary record of each contract
- A central technology infrastructure that automates and standardizes trade processing, such as record keeping, payment calculations and settlement, notional adjustments and contract term changes over a contract's life.

**5. Which OTC derivatives trades are eligible for the TIW?**

While DTCC Deriv/SERV supports electronic confirmation for rates, credit and equity asset classes, only credit derivative transactions are presently eligible for the Trade Information Warehouse (TIW). TIW was launched in November 2006. All credit derivative transactions confirmed since the inception of TIW automatically flow into TIW for position and post trade event maintenance. For credit derivative transactions confirmed prior to November 2006, a backload facility is provided to allow DTCC Deriv/SERV participants to upload these transactions into TIW.

**6. How can a buy side firm gain access to metrics to measure progress against the industry standards?**

DTCC Deriv/SERV and other providers will make reports available for TIW sourced records that will directly address the targets described in the industry letter. These reports could be used to aid the buy side in measuring its performance on an individual basis and further help them to evaluate the performance of trading partners in a constructive way. Firms are able to access these reports via the service provider or the DTCC Deriv/SERV web interface on a monthly basis.

**7. Will DTCC Deriv/SERV issue reports to buy side firms to monitor the standards based on the Fed letter? Will these reports be volume based? Will these reports be submitted to the regulators?**

DTCC Deriv/SERV will generate metric reports on a monthly basis that will directly address the targets described in the industry letter. These reports are automatically generated for any DTCC Deriv/SERV participant that has greater than 150 new transactions per month. Upon request, DTCC Deriv/SERV can activate the generation of these metric reports for lower volume clients as well. These reports will not be submitted to regulators, although regulators will look at how the buy side is performing as an industry against the targets in the letter. Therefore, any firm participating in the OTC derivatives market should strive to meet these goals as a matter of sound practice.

**8. What are RED codes? How do firms become a subscriber?**

Markit's Reference Entity Database (RED) codes are standard identifiers that are used to link the legal relationship between reference entities that trade in the credit default swap market and their associated reference obligations, known as "pairs". Each entity is identified with a unique 6-digit alphanumeric code, and a 9-digit code identifies the pair. RED codes are used by CDS market participant subscribers to electronically match and confirm CDS transactions. In May 2008, Markit announced a new freely available license for RED codes, aimed at smaller buy-side firms. Please feel free to contact Markit to subscribe to this data. ([www.markit.com](http://www.markit.com)).

**9. Some of the dealers have been proposing a central clearing facility. What is the status of this initiative?**

The Clearing Corporation is working with a group of CDS market participants on creating a clearing house for credit default swaps. This clearing house would essentially act as a central counterparty to its participants, guaranteeing all CDS transactions accepted for clearing and collecting margin and other credit support from its participants to collateralize their clearing obligations. The Clearing Corporation will begin by clearing trades on North American CDS indices. After the service is operational, European indexes, index tranches and single name CDS transactions will be added. Regulators are encouraging this solution.

Participation in the clearing house will be open to all qualified clearing participants (both dealers and non-dealers). In order to qualify as a clearing participant, a firm will be required to satisfy the clearing house's participant criteria. According to The Clearing Corporation, these criteria are currently expected to include the following requirements:

- minimum net capital of \$5 billion;
- minimum long-term debt rating of "A" from S&P (or equivalent from another nationally recognized rating agency);
- demonstrated operational competence in CDS, including positions having a minimum outstanding notional contract value of \$500 billion;
- demonstrated risk management capabilities; and
- participation in CDS industry organizations (such as the International Swaps and Derivatives Association and DTCC's Deriv/SERV).

**10. What are some of the solutions for reducing the size of outstanding notional or the number of trades?**

The central counterparty clearing initiative is a dealer-led initiative. The intended purposes are to reduce systemic risk and improve capital and operational efficiency by multi-laterally netting contracts thus reducing the outstanding notional values and reducing the outstanding number of trades that need to be tracked until maturity.

In addition, TriOptima, Markit and Creditex provide tear-up/portfolio reconciliation/compression functionality to dealers and some buy-side firms.

**11. What are the existing challenges in collateral management and how can they be addressed?**

Collateral management is a significant challenge for industry participants to monitor and control their exposure on outstanding derivatives positions. Buy-side firms should implement electronic messaging for collateral movements and proactively manage pledged collateral through a daily pricing and a regular reconciliation process. Two service providers and several custodians offer automated collateral platforms for the collateral processing cycle.

## 12. What are the criteria for becoming a member of the Operations Management Group?

The OMG was originally formed by major derivatives dealers and now includes representation from several asset management firms and hedge funds. The industry's three primary trade associations were invited to participate as observers. Individual OMG representatives are often heads of derivatives operations at their respective firms. Firms are encouraged to become active participants in the relevant industry associations as a first step toward active industry involvement. These associations have committees open to broader member participation.

## Confirmation / Affirmation Questions

### 13. What electronic confirmation systems exist and what steps are needed to onboard to these systems?

DTCC Deriv/SERV and MarkitWire are the most common confirmation platforms for electronically confirming OTC derivative transactions. Markit and other service providers such as T-Zero and Tradeweb provide affirmation services for credit derivatives. Firms should evaluate the various electronic confirmation options and select a service provider that meets their needs. The firm's trading, operations and legal and compliance departments should be involved in the on-boarding process.

### 14. What are the options for connecting to an electronic confirmation system?

Buy side firms can connect to confirmation services in various ways, e.g. directly, through a prime broker or through service providers. Order Management Systems can connect to confirmation platforms through various methodologies such as GUI's, API's, FIX, FpML or XML connections or through spreadsheet upload (i.e. flat files). Firms with higher volumes can also build MQ feeds that would link the firm's order management system with the electronic confirmation platform. Some buy side firms use prime brokers as intermediaries to connect to electronic confirmation platforms.

### 15. Which trades can be confirmed electronically?

- DTCC Deriv/SERV supports all credit derivatives transactions for which there is a standard supplement, all ISDA published interest rate templates (not including cross currency) and all ISDA equity derivatives templates. Credit derivative transactions automatically flow to the Trade Information Warehouse for post-trade event processing once confirmed. (For more information visit [www.dtcc.com/products/derivserv](http://www.dtcc.com/products/derivserv))
- MarkitWire supports credit derivatives, interest rates and equity derivatives. ([www.swapswire.com](http://www.swapswire.com))

### 16. How can firms monitor the accuracy rates of submission to electronic confirmation systems?

Buy side firms should work with their electronic confirmation service provider partners to obtain this information.

## Novation Questions

### 17. What are the options for electronically novating credit derivative trades?

DTCC Deriv/SERV and T-Zero are the most common platforms that are used to electronically novate credit derivative trades. Firms also have the option of novating trades directly through the Trade Information Warehouse using the DTCC GUI.

### 18. What is the timeline for obtaining consents to novations via electronic platforms, and is the 6 p.m. deadline set forth in the novation protocol still in effect?

Market participants have established a cut-off time of 6 p.m. ET (NY time) as the deadline for obtaining novation consent and this applies equally when processing consents via electronic platforms.

### 19. If a buy side client submits a novation via electronic platform at 5:45 p.m. will they make the 6 p.m. deadline?

If the novation request is accurate and complete, the Remaining Party can respond in sufficient time to meet the 6 p.m. deadline.

### 20. How long does a novation platform need to process a request and will that change the protocol deadline for novations requested through an electronic platform?

Most electronic platforms can deliver individual novation consent requests in milliseconds. However, the terms of the ISDA Novation Protocol itself would not change unless an amendment to the protocol is signed by all adhering parties to the Protocol.

### 21. Are novations for interest rate swaps done through MarkitWire subject to the minimum processing standards outlined in the March 27th industry letter?

No. While the novation protocol covers interest rate swaps, the commitment to novate trades electronically applies to electronically eligible credit derivative transactions. Counterparties should make every effort to use electronic solutions for as many asset classes as possible to facilitate an efficient and timely process.

### 22. What automation do dealers currently have in place for novations and can they share related best practices?

The dealers will be required to have electronic processing for novation consents and be able to inter-connect or accept novation requests from the primary service provider platforms (DTCC and T-Zero) by end of 2008. The major dealers will use one or multiple electronic novation solutions. At publication of this FAQ, the only live solutions for electronic novation processing are DTCC and T-Zero.

**23. What will the deadline time be for amended allocations?**

Buy side clients should be able to amend allocations with the dealer on trade date. However, there will be times when allocations are amended post T+0 but the net of all cash flows should match between the dealer and the buy side firm. Amended allocations are expected to happen very infrequently and dealers' procedures for making changes after trade date will vary; some dealers' compliance organizations have strict procedures around allocation changes.

**24. Have service providers created ways to notify clients of inaccurate allocation submissions upon the novation of existing positions?**

If a client is novating from their existing positions within Trade Information Warehouse or T-Zero or through the DTCC Novation GUI, they would not be able to request a change in the current allocated notional amount. If a client were to submit an 'outside novation' and fill in the details themselves, technically they could ask for an inaccurate allocation but assuming the dealer locates the right trade, the dealer would not be able to novate and would decline the novation request. When the novation process is managed via electronic systems and not email, these discrepancies will be very rare, and only occur when a buy side firm is proposing an outside novation.

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## Appendix

The Operations Management Group (OMG) which comprises dealer firms, buy-side institutions and industry trade associations issued a letter on March 27, 2008 to the Federal Reserve Bank of New York in support of its mission to effect fundamental change in the processing of OTC derivative transactions. The expectation is that all credit derivatives market participants should meet the minimum operating standards below. The goal is to align the processing of other electronically eligible OTC derivative products to these standards as well.

### Use of Electronic Confirmation Platforms:

Market participants should onboard onto electronic confirmation platforms promptly and should submit or accept alleged transactions electronically within 60 calendar days of each new product or service launch.

### Electronic Confirmation Targets:

The industry goal is to match as many trades as possible on trade date. As a major step toward this goal, all market participants should strive to meet the following objectives and targets for electronically eligible trades:

	OBJECTIVES	2008 TARGETS
Submission	Majority of trades submitted on T+0 with the remainder by T+1 Trades submitted accurately	90% of trades submitted on T+1 (or affirmed within 1 day of submission) 90% of trades matched without amendment
Matching	Majority of trades matched on T+0 with the remainder by T+5	92% of trades matched by T+5
Standard Identifier	Standard identifiers submitted accurately for Reference Entities and Reference Obligations	RED subscribers to accurately submit 9-digit RED codes on 100% of index trades and 90% of single name trades

### Allocations:

All trade allocations should be provided on T+0 in order to meet the goal of matching trades on trade date. Participants are expected to invest in allocation automation through vendor or direct solutions during 2008.

### Novations:

The industry objective is to have novation requests for electronically eligible trades submitted via electronic platforms rather than emails. Market participants are expected to invest in a strategic, interoperable novation workflow solution through 2008.

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