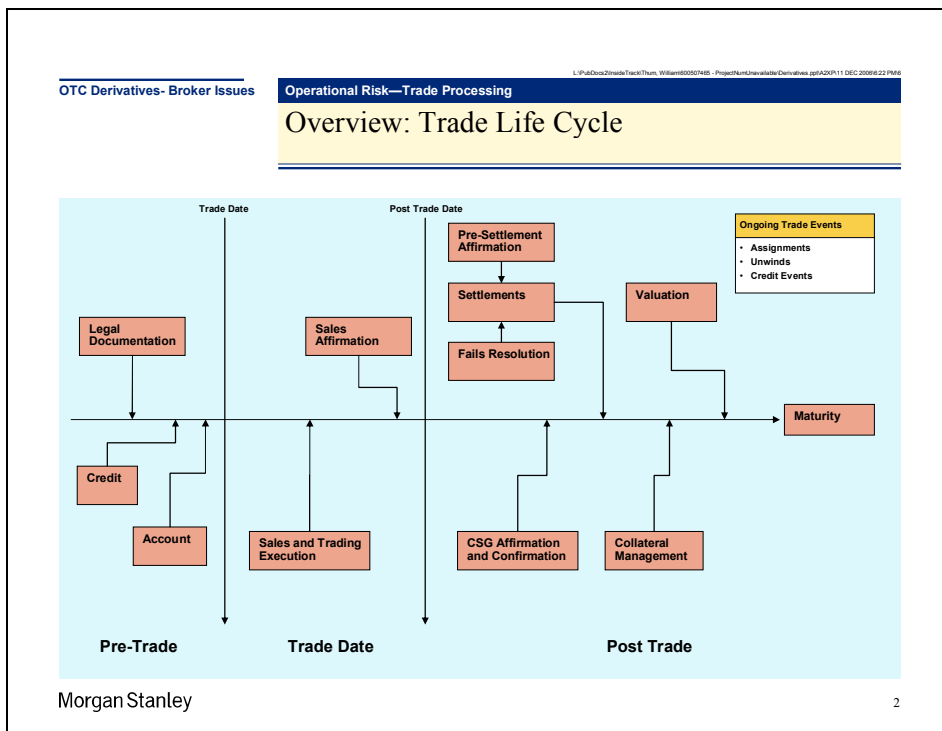


L:\P\Docs\Trade\TradeThum_William05057465 - Project\NetUnwindable\Derivatives.ppt\ADXP11 DEC 2006\622 PM1

OTC Derivatives- Broker Issues

02 July 2007

Morgan Stanley



L:\P\Docs\2106\Topic7\um_william05057465_Paper\um_william05057465\Derivatives.pdf\A230111 DEC 2006\22.PM33

OTC Derivatives- Broker Issues Documentation—Controls

New Client On-Boarding

A2/DARWIN—database of validated parties

- Legal name
- Capacity class
- Jurisdiction
- Anti-money laundering
- U.S. tax forms
- Content leveraged across all risk systems

E*DART—Electronic Document and Account Request Tool

- Web-based tool for swaps, repos, FX and commodities
- **Sales:** inputs party name and attributes, proposed business, trade timing
- **Credit:** analyzes credit risk and sets credit terms to approve trading
- **ISD (Docs):** assesses capacity and authority of party to do proposed trading
- **Portfolio Management:** determines credit pricing and credit risk mitigation techniques

Morgan Stanley 3

L:\P\Docs\2106\Topic7\um_william05057465_Paper\um_william05057465\Derivatives.pdf\A230111 DEC 2006\22.PM37

OTC Derivatives- Broker Issues Documentation—Controls and Crisis Management

New Client On-Boarding (cont'd)

Customer Identification Procedures (“CIP”)

- U.S. Treasury Department regulations issued April 2003
- Section 326 of Patriot Act requires a CIP to verify the identity of clients
- Requirements:
 - Formation Documents
 - articles of incorporation, trust agreement, etc.
 - Disclosure Documents
 - offering memorandum, prospectus, etc.
 - List of Principals
 - directors, trustees, general partners
 - Government Identification Number
 - tax-payer ID

Morgan Stanley 4

L:\PubDocs\2151a\Topic\Thun, William\0207465 - Project\Run\2151a\Derivatives.ppt\207111 DEC 2006 22 PM37

OTC Derivatives- Broker Issues Documentation—Controls and Crisis Management

New Client On-Boarding (cont'd)

Capacity and Authority Review

- Does the client have the corporate POWER and has the delegation of such power been AUTHORIZED for the client to do the proposed trade?
- ISD reviews the following:
 - Capacity: By-laws, Articles of Incorporation, etc.
 - Authority: Memorandum and Articles of Association, etc.
 - Agency: Investment Management Agreement, etc.

Tax Representations and Forms

- Parties make representations regarding tax status, and provide U.S. tax forms to address any withholding tax which might arise in a transaction
- For parties which cannot be validated as being exempt recipients (corporation, U.S. pension plans, etc.), they must provide a tax form
 - U.S. parties: W9
 - Non-U.S. parties: W8-BEN (for beneficial owners)
W8-ECI (for payments connected to a party's U.S. business)
W8-IMY (for intermediaries)
W8-EXP (for sovereigns, international organizations)

Morgan Stanley 5

L:\PubDocs\2151a\Topic\Thun, William\0207465 - Project\Run\2151a\Derivatives.ppt\207111 DEC 2006 22 PM37

OTC Derivatives- Broker Issues Documentation—Controls and Crisis Management

Documentation Management Tools and Controls (cont'd)

Documentation Policy

- Product risk profile: FX, PB, OTC, Commodities, Repos/Stock Loan
- Client risk profile: Classified by legal and enforceability risks
- Issues addressed:
 - Disclosure of principal
 - Capacity and authority checks: method and timing
 - Master agreement and credit support docs: timing and content

User's Guide

- ISDA Master ('92, '02): section analysis, policies, decision tree
- Annotated templates: Repos, FX, Commodities, Futures, PB

Template Management

- Global website
- Periodic review and validation (DPG approval)

Morgan Stanley 6

L:\PubDocs\2\issae\Topic\Thum_William\60507485 - Project\RM\Alternative\Derivatives.ppt\4209111 DEC 2006\22 PM12

OTC Derivatives- Broker Issues

Legal Risk—Enforceability and Netting

CSE/Basel II/GAAP

- Legal enforceability review of trading/netting agreements is required before benefiting from netting or collateral for capital or accounting purposes.
- Basel II: “Well-founded legal basis” + enforceable in each relevant jurisdiction (Paragraphs 118, 188).
- CSE: Legally enforceable in each relevant jurisdiction.
- US GAAP: Reasonable assurance that netting is legally enforceable.

Industry Groups

- Participation by Law Division and Documentation group members on ISDA, TBMA, ISMA, FMLG, EEI and other industry group committees covering documentation and legal matters.
- Access to ISDA, ISMA, FMLG and other legal opinions covering master agreements.
- Subscription to legal opinion databases
 - Netalytics
 - CS Analytics
 - Law firm databases

Morgan Stanley

7

L:\PubDocs\2\issae\Topic\Thum_William\60507485 - Project\RM\Alternative\Derivatives.ppt\4209111 DEC 2006\22 PM16

OTC Derivatives- Broker Issues

Legal Risk—Enforceability and Netting

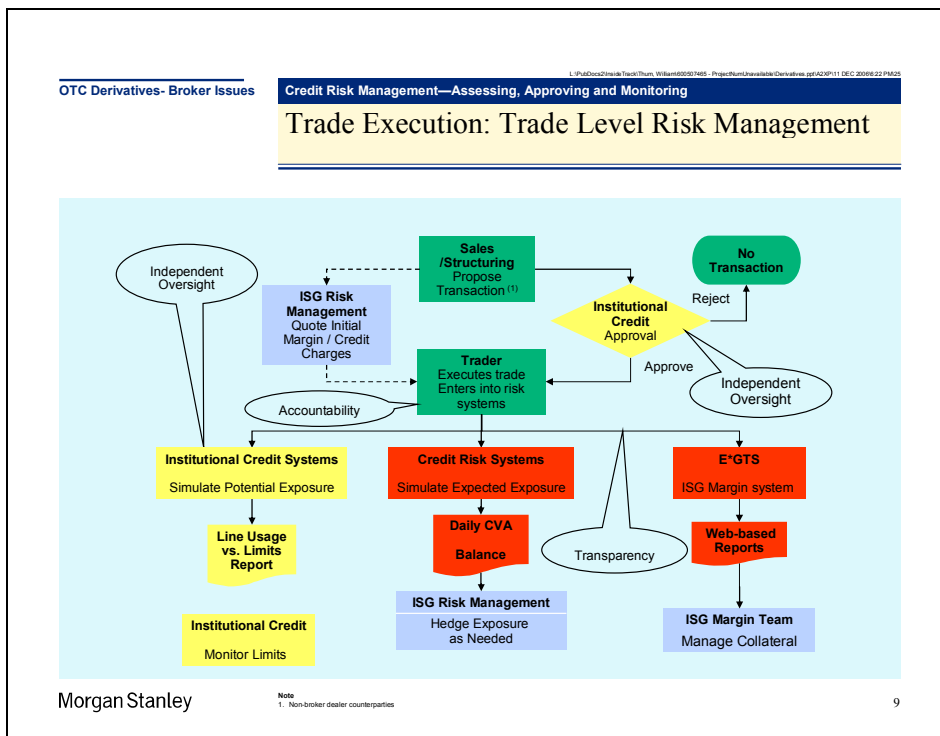
Post-Execution

Legal Enforceability Project

- Close-out netting analysis
- Collateral enforceability analysis
- Rating scale:
 - 1 = Highly Confident
 - 2 = Confident
 - T2= Temporary rating category (eg., pension funds, insurance companies)
 - S2= Temporary rating category for sovereigns and supranational entities
 - 3= Not Confident

Morgan Stanley

8



- OTC Derivatives- Broker Issues
- Credit Risk Management—Assessing, Approving and Monitoring
- ### Trade Execution: Initial Margin Approach
- Initial Margin Approach Summary**
- Trade by Trade Approach
 - Initial margin applied to each new transaction
 - Standard grid approach
 - Specific trade/asset-based approach determined by liquidity/volatility
 - Package Trade Approach
 - Initial margin applied to each new transaction package generally to one leg
 - Trades linked in trade confirmation
 - Portfolio-based Approach
 - Initial margin calculated on a portfolio basis reflecting risk, volatility and liquidity of underlying trades
 - Portfolio-based methodologies include:
 - VaR-based calculation
 - Scenario/Stress-based calculation
 - Prime Brokerage Relationships
 - Bridged arrangements allow for consolidated / portfolio margining
 - Margin relief may be given for bond/cds and equity/derivative packages
- Morgan Stanley
- 10

L:\P\Doc\2006\Trade\Thom_William\05057465_Project\New\Operational\Derivatives ppt\200711 DEC 2006\22 Ppt6

OTC Derivatives- Broker Issues Operational Risk—Trade Processing

Documentation Policies (Pre-Execution)

- We are working towards “steady state” as described in the SOG letter to the regulators

Operational Functions:

- Trade Capture
 - Ensure all economic/non-economic trade details required to support transaction lifecycle are captured in risk management system on trade date
- Trade Affirmation – Acknowledgement (email, Bloomberg, etc) on trade date of key economic fields used for confirmation
- Trade Confirmation
 - Ensure that all key economic details are acknowledged as close to execution as possible;
 - Ensure that all economic/non-economic details are agreed by both parties in a legally binding contract
- Trade Maintenance
 - Ensure Risk Management systems have key market data fed for position management
 - Reset notices/Settlements – are issued and agreed as required
 - Collateral Management – ensure daily margin calls are issued and agreed
 - Valuation Statements – ensure statements are delivered as needed;

Morgan Stanley 11

L:\P\Doc\2006\Trade\Thom_William\05057465_Project\New\Operational\Derivatives ppt\200711 DEC 2006\22 Ppt6

OTC Derivatives- Broker Issues Operational Risk—Trade Processing

Operations Initiatives

Confirmations Services:

- Markit (text)
- DTCC (electronic)
- Swapswire (electronic)
- CMS (FX)

Trade Capture Vendors:

- TradeWeb
- TZero
- Markit
- Omgeo

- ISDA confirms are generated as close to execution as possible
- CDS via DTCC
 - DTCC Deriv/SERV, a matching service for derivatives for post-trade processing;
 - Includes PAY/REC service for payment matching for quarterly roll and also
 - **Trade Information Warehouse**—a central industry infrastructure for the global, over-the-counter (OTC) derivatives market.
- IRS via Swapswire
 - SwapsWire is an industry-backed electronic platform designed to promote efficiencies for the OTC derivatives market
- Equity OTC – via SwapsWire & DTCC
- Working towards Steady State for CDS Business
 - Trades that can be confirmed electronically – T+5; if not confirmed, verbal affirmation on t+5
 - Trade that can be confirmed on paper – T+30; dispatched by t+10 with comments/updates by t+20
- Equity Derivative Processing Review:
 - Streamline the MCA process and
 - Confirms executed to the same standards as CDS
 - January 31, 2007—25% reduction in number of unexecuted trades over 30 days

Morgan Stanley 12
