MiFID II Understanding and Practical Preparation

AN ACA COMPLIANCE (EUROPE) SERIES

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Transaction Reporting - What is Changing Under MiFID II

Transaction Reporting

This paper forms part of MiFID II: understanding and practical preparation – an ACA Compliance (Europe) series of communications prepared to help our clients understand this significant reform of the European regulatory landscape and to ascertain the direct and indirect implications for their own businesses. The transaction reporting regime currently in place, which is derived from the original Markets in Financial Instruments Directive (hereafter referred to as "MiFID I"), will be overhauled and greatly expanded in terms of its scope and content. This article sets out the key issues investment managers need to consider in relation to the transaction reporting obligations that will apply under MiFID II.

What is transaction reporting for?

MiFID I, which came into force in 2007, represented the European Union's ("EU") first attempt to regulate financial markets, and it introduced, for the first time, a harmonised transaction reporting regime across the EU. In MiFID II, the European Commission ("EC") takes the current objective of transaction reporting - the detection and investigation of potential market abuse – and expands it into supporting "market integrity". The proffered definition - "monitoring the fair and orderly functioning of markets[1] " - is no more precise but the new approach is perhaps better illustrated by specific new areas of focus – the identification of waivers for large orders and illiquid instruments, short selling and the application of commodity derivatives.

The proposed amendments to transaction reporting are contained in MiFIR - a regulation[2], meaning that these have direct force across the EU without the possibility of national differences in implementation.

Which types of firm are caught?

MiFID II (and hence the obligation to transaction report) applies to all "investment firms", including investment managers providing investment advice and portfolio management on a client-by-client basis (e.g. managed accounts).

MiFID II does not, in the first instance, apply to investment managers who purely carry out collective portfolio management of Alternative Investment Funds ("AIF") and UCITS. So a CPM firm (as defined by the FCA) is out of scope, whereas a CPMI firm is in scope, but only in respect of its managed account activities.

[1] Recital 32 of MiFIR

[2] The primary legislation consists of Directive 2014/65 ("MiFID II") and Regulation 600/2014 ("MiFIR"). Collectively, these are also known as "MiFID II". Article 26 of MiFIR is the relevant section for transaction reporting.

That said, in the UK, AIFMs and UCITS managers are subject to the current MiFID I transaction reporting regime, and it seems highly likely that the FCA (and other national regulators) will extend the obligation to fully include both of these categories.

Which financial instruments need to be reported?

Under MiFID I, transaction reporting applies only to financial instruments[3] admitted to trading on a regulated market, plus any OTC contract which derives its value from any such instrument.

MiFID II broadens the scope of transaction reporting to capture:

i. Financial instruments admitted to trading or traded on an EU trading venue or for which a request for admission has been made. "Trading venues" now include Multilateral Trading Facilities ("MTF"), the new category of Organised Trading Facilities ("OTF"), the likely home for OTC derivatives subject to the trading obligation, as well as regulated markets.

ii. Financial instruments where the underlying instrument is traded on a trading venue. This essentially widens the scope to capture all OTC transactions in such instruments.

iii. Financial instruments where the underlying is an index or a basket composed of instruments traded on a trading venue. This means that just one component of either an index or basket will bring that financial instrument under the reporting obligation.

Note that the transaction does not actually need to have been executed on an EU trading venue. Hence, for example, derivatives traded outside the EU where the underlying is traded on an EU trading venue will have to be reported.

What is a "transaction"?

The proposed definition of a transaction covers the "acquisition, disposal or modification" of a reportable financial instrument, including but not limited to:

- A purchase or sale (this is the current MiFID I definition);
- A simultaneous acquisition and disposal where there is an obligation to publish post-trade, even if there is no change of beneficial ownership (e.g. when exercising options); and
- The entering into or closing out of such an instrument.

Exclusions from the definition of transactions include:

- Securities financial transactions (e.g. stock lending, repurchase agreements);
- Post-trade assignments and novations in derivatives;
- Portfolio compressions;
- The creation, expiration or redemption of instruments resulting from pre-determined contractual terms or mandatory events where no investment decision is occurring; and
- A change in the composition of an index after a transaction has taken place.

"Execution" is also a distinct concept in the new regime - defined as any action that results in a transaction. In other words, the transaction is the outcome; the execution is the activity that results in that outcome.

Which parties to a transaction must report?

Under MiFID I, the reporting obligation carried an exemption for firms that can reasonably rely on a third party to make reports on their behalf. The FCA interpreted this fairly broadly, meaning that discretionary investment managers can rely on their brokers (assuming they are MiFID investment firms) to transaction report.

[3] Defined in Annex 1, Section C

It is important to understand that this exemption is only partially carried forward to MiFID II, and then only with a number of important conditions attached. MiFID II introduces the concept of a discretionary investment manager "transmitting" an order to a broker for execution. The conditions for meeting what seems likely to be known as the "transmission exemption" are discussed in the next section.

The transmission of orders "exemption"

The first condition is that the "transmitting firm" (e.g. a discretionary investment manager) is only deemed to have successfully transmitted an order when it has sent certain specified details to the "receiving firm" (the broker), including the details of the trade, the client or clients for whom the transaction has been made (if across a number of funds or accounts), and a designation to identify short sales.

The second essential requirement is a written transmission agreement in place with the receiving firm. This must specify the circumstances under which the details of the order will be considered properly transmitted, the time period for providing such details, and confirmation that the receiving firm is itself a MiFID investment firm.

The transmission exemption thus provides a mechanism for investment managers to continue to rely on their brokers to report on their behalf. Where it becomes operationally more challenging, in our view, is the additional granularity of reporting data – more on this in "What are the contents of transaction reports?" below.

Note that investment managers will not be able to rely on transmission to non-EU counterparties and therefore may need to retain some capability to make their own reports.

Even where investment managers effectively rely on others to report, they must nevertheless "take reasonable steps to verify the completeness, accuracy and timeliness" of such reports (See "What must I do to demonstrate compliance?" below).

The mechanics of reporting

As indicated above, there will be a variety of reasons why some investment managers will have to make their own transaction reports: e.g. firms executing their own decisions to trade, or firms engaging non-EU brokers (i.e. where not MiFID authorised).

The basic obligation is for investment firms which execute transactions to report to their home-state national competent authority (i.e. the FCA for UK firms) "as quickly as possible" and no later than the close of the following working day ("T+1"). (See below for the content of such reports).

Firms may file the reports either directly, or through an Approved Reporting Mechanism ("ARM"), or via the trading venue through which a transaction was undertaken.

ARMs were first introduced in the UK through the Financial Services and Markets Act 2000 ("FSMA"), but the concept is now extended to the rest of the EU, with MiFID II imposing organisational requirements for such entities. We anticipate that they will become a much more widely used facility within the trading landscape.

What are the contents of transaction reports?

The number of data fields required in the reports will rise significantly: from 23 fields under MiFID I, to no fewer than 81 under MiFID II. Only 13 of the 23 existing fields remain unchanged (the basic details of the transaction).

One particular area of concern is the more exacting details required for identifying the client. Under MiFID I (as prescribed in FCA guidance) it is sufficient to name the investment management firm responsible for initiating the transaction in the "client" field. Under MiFID II, each and every client (fund, account or natural person) will have to be identified in a standardised format. For funds and managed accounts this must be a valid Legal Entity Identifier ("LEI") code.

In addition, there are completely new requirements to identify both the originator of the decision to trade and those executing it. These include:

i. A natural person making the decision to acquire or dispose of a reportable financial instrument or modify an existing contract (e.g. the portfolio manager). This must be done according to the formula set out in Annex II of Draft RTS 32, including a two letter nationality code;
ii. A committee making such a decision, using a unique identifying code with the prefix "COM". Where this applies, firms must keep adequate records of the composition of the committee, and provide those to the FCA on request;
iii. A person executing a transaction (e.g. the trader);
iv. An algorithm making a decision to trade (this must be unique and exclusive to each and every trading strategy constituting an algorithm) ; and
v. An algorithm actually executing a transaction.

Another layer of new detail is the required flags for certain types of trade referred to above, including:

i. Waiver indicator, for transactions executed under a pre-trade waiver (e.g. "L" for "Large in scale, "I" for "Illiquid Instrument) ;
ii. Short sale indicator ("Y" for a short sale not carried out under the market maker exemption, and "N" for "no short sale) ; and
iii. Commodity derivative indicator, stating whether a transaction "reduces risk in an objectively measurable way" (Y or N) .

These additional levels of granularity will represent major operational challenges to buy-side firms. Bearing in mind the identification of natural persons (including dates of birth and residence post codes for the client field, and ID/Passport numbers for traders making investment decisions and executing), concerns have also been raised about data protection and privacy laws in a number of national jurisdictions.

Are there any overlaps between derivatives reporting under EMIR and transaction reporting under MiFID II?

The short answer is, in our view, "not many". There were early proposals, for example, from the EC to waive the MiFID II obligation on an investment firm that had already reported an OTC derivative contract under EMIR. However, although there are similar requirements in terms of the basic trade identification (the "what, where and when" questions), the new levels of detail quickly meant that there was little chance of reconciling the two regimes.

In our view this divergence is likely to be permanent. EMIR is fundamentally designed to monitor systemic risk, whereas MiFID II aims to tackle market abuse and other micro-structural issues.

What must I do to demonstrate compliance?

The FCA has recently brought a swathe of enforcement actions against firms for transaction reporting failings under MiFID I. Typical breaches included reporting inaccurate trade times, incorrect identification of counterparties, incorrect use of buy and sell indicators, incorrect identification codes and failure to report listed derivative trades.

MiFID II brings with it a renewed emphasis on the accuracy of reports: for example, Recital 35 of MiFIR states that “Double reporting of the same information should be avoided”. Similarly, the FCA has stated that they will no longer tolerate the over-reporting of transactions (this occurs when firms take an “If in doubt, report” approach). It is likely that further guidance will be provided in the expected update of its Transaction Reporting User Pack (“TRUP”).

In our view, this is likely to mean that a simple annual confirmation from your counterparties that they are transaction reporting on your behalf will no longer be sufficient. At a minimum, firms will need to analyse an appropriate sample of reports, and demonstrate pro-active procedures to correct any errors identified (particularly where these form a consistent pattern).

What should I be doing now to prepare?

The clock is ticking: there is only 18 months at the time of writing to “go live”. We expect regulators, especially the FCA, to be intolerant of firms who have not implemented the appropriate systems and processes by 3 January 2017. Naturally, there will be circumstances specific to your firm, but any checklist of actions will probably include:

- Analysing the universe of your transactions to work out what must be reported and whether, and in what circumstances, you can avail yourself of the transmission exemption;
- Speaking to counterparties about the necessary transmission agreements;
- Looking at possible ARM arrangements to report residual transactions;
- Discussing with IT and back office how to cut the required data, and allocating budgets for any necessary upgrading of systems;
- Considering the impact on your compliance monitoring programme.

How ACA will support you

Although transaction reporting is first and foremost an operational issue, we anticipate assisting our clients in understanding the scope of the new transaction reporting requirements, interpreting the use of the transmission exemption, and updating compliance documentation and monitoring programmes.

More generally, in the run up to January 2017, we are planning further client communications in this series to help our retained clients understand the major potential impact areas of MiFID II on their businesses.

Please contact **Mary Campion**, **Martin Lovick** or your usual ACA contact with any specific questions or concerns arising from this paper.

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