



FIA AND FIA EUROPE SPECIAL REPORT SERIES: TRANSACTION REPORTING UNDER MiFID II

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This Special Report is the seventh in the FIA and FIA Europe's series covering specific areas of the European Securities and Markets Authority's consultation process for the implementation of the recast Markets in Financial Instruments Directive (the MiFID II Directive) and Markets in Financial Instruments Regulation, which together are referred to as "MiFID II" and come into effect on 3 January 2017. On 19 December 2014, ESMA published final Technical Advice to the European Commission, together with a Consultation Paper on MiFID II implementation. The Consultation Paper includes draft Regulatory Technical Standards (RTS) and Implementing Technical Standards (ITS), which ESMA is required to produce under MiFID II.

This Special Report provides an overview of ESMA's proposals in the Consultation Paper and the draft RTS on the obligation for investment firms to report transactions under Article 26 of MiFIR. The Consultation Paper covers five specific aspects of market data reporting: the obligation to report transactions; the obligation to maintain records of orders; the requirement to maintain records of orders for firms engaging in high frequency algorithmic trading techniques; the obligation to supply financial instrument reference data; and clock synchronisation.

THE OBLIGATION TO REPORT TRANSACTIONS

Article 26(1) of MiFIR requires investment firms "executing transactions in financial instruments" to report to the national competent authorities (NCAs) details of those transactions in order to enable the NCAs to detect and investigate potential instances of market abuse, and to help the NCAs monitor the functioning of markets and investment firms activities. "Complete and accurate details" must be reported to the NCAs "as quickly as possible", but in any event, no later than the close of the following working day.

Under Article 26(7) of MiFIR, investment firms may file the reports directly, through an Approved Reporting Mechanism (ARM), or through the trading venue through which a transaction was completed. Reporting to a trade repository under the European Markets Infrastructure Regulation (EMIR) would also satisfy the MiFIR reporting obligation, provided that the EMIR report contains at least the same information as the report required by MiFIR. It should be noted however that whilst these different options to report exist, currently in the U.K. the Financial Conduct Authority (FCA) requires trading venues, firms and trade

repositories to register as an ARM prior to accepting any reporting. Furthermore, MIFID and EMIR are reporting regimes that have been set up for different purposes with the MIFID/MIFIR primary purpose being market abuse monitoring, and EMIR being aimed at systemic risk monitoring. As such the regimes, whilst having an overlap, require fundamentally different sets of information. As such an EMIR report would not fulfil a MIFID/MIFIR reporting requirement without significant data enhancement.

Article 26(3) of MiFIR sets out the details which transaction reports should include as a minimum. These are (i) information on the financial instruments bought or sold, such as names and numbers of the financial instruments, quantity and dates and times of execution; (ii) identification of the client on whose behalf the investment firm has executed the transaction; (iii) identification of the investment firm, as well as the person and the computer algorithm within the investment firm responsible for the investment decision and the execution of the transaction; and (iv) a designation to identify a short sale. Under Article 26(9) of MiFIR, ESMA is asked to develop draft RTS in relation to these aspects of the reporting obligation.

DEFINITIONS OF TRANSACTION AND EXECUTION

ESMA's Discussion Paper published on 22 May 2014 (the May Discussion Paper) outlined a number of principles for determining whether an investment firm has executed a transaction for the purposes of the MiFIR reporting obligation. The draft RTS on reporting obligations under Article 26 of MiFIR (RTS32) set out ESMA's definitions of "transaction" and "execution" of a transaction. Article 3 of RTS32 sets out these definitions.

ESMA defines "transaction" at Article 3(2) of RTS32 as "an acquisition, disposal or modification of a reportable financial instrument" and states that an "acquisition or disposal" will include (but will not be limited to) a purchase or sale of a reportable financial instrument; the simultaneous acquisition and disposal of a reportable financial instrument, where there is no change in beneficial owner of the instrument, but where post-trade publication is required; and entering into or closing out of a reportable financial instrument. For the avoidance of doubt, the Consultation Paper confirms that this definition includes any decrease or increase in notional before the expiry date of a reportable financial instrument. ESMA has further clarified that "decrease or increase" in notional refers to the OTC asset class and not to exchange traded derivatives (ETD). ESMA also includes a list of "transactions" that will not be included in the definition of "transaction" for these purposes. These include contracts for clearing or settlement purposes; post-trade assignments and novations in derivatives where one of the parties to the contract is replaced by a third party; portfolio compressions; and internal transfers within the investment firm of reportable financial instruments which are held by the investment firm for its own account and/or the account of a client, which do not lead to a change in beneficial ownership of the instrument.

ESMA defines "execution" at Article 3(4) of RTS32 as "any action irrespective of on whose behalf these actions are undertaken, that results in a transaction if such action in a chain of events leading to the transaction is of enough importance that without that involvement the transaction would not have taken

place". As with the definition of "transaction", ESMA sets out some circumstances which will be included and some which will not. The definition of "execution" will include where an investment firm takes action itself, including taking action through a branch of the firm, regardless of whether the branch is located inside or outside the European Union; where an investment firm receives an order for one or a number of clients and sends that order to a third party, but without complying with the conditions set out in the RTS32 for transmission of an order; and where acting on a discretionary basis, the investment firm places an order with a third party without complying with the conditions for successful transmission of an order. ESMA's list of matters which will not be "execution" is rather shorter than the corresponding list for "transaction" and amounts to only two circumstances: investment advice; and where the investment firm introduces two parties to each other without interposing itself between those parties.

In the Consultation Paper, ESMA provides its reasoning for the definitions in RTS32. It states that the transaction is the outcome and the execution is the activity by the investment firm that results in that outcome and hence, ESMA has defined these separately. ESMA believes that direct action by the investment firm is clearly "execution", whether inside the European Economic Area or not. ESMA also believes that, in addition, where an investment firm instructs third parties and a transaction results, this also constitutes execution.

TRANSMISSION OF AN ORDER

Article 26(4) of MiFIR requires investment firms that transmit orders (that is, firms that pass on details of orders received from their clients to other investment firms and firms which act on a discretionary basis that place orders with other investment firms) to include the reporting details in the transmission of those orders, unless they report the orders themselves. Article 4 of RTS32 provides the requirements which must be fulfilled to transmit an order successfully.

ESMA has stressed that there is little room to simplify the approach required under Article 26 of MiFIR and so the components of Article 4 of RTS32 remain largely unchanged from the May Discussion Paper.

ESMA has, though, provided clarification on perceived problematic issues in the Consultation Paper. It explains that receiving firms do have the ability to refuse to enter into a transmission agreement, but that if they do enter into one, they must transaction report the transmitted details unless the requirements for the transmission details as set out in the RTS have not been complied with correctly (in which case the transmitting firm must make the report). ESMA does not intend to provide prescriptive requirements for the content of a transmission agreement.

ESMA also clarifies that relevant price conditions (such as the limit price) should be included in the order, and that the quantity and price reported should be the actual quantity and price of the resulting transaction. Receiving firms will be able to report based on their own reference data, but they must include specific information from the transmitting firm on the client and on aggregation allocations. On timing, ESMA acknowledges that not all of the required

information is likely to be available to the receiving firm at the time of transmission. Such information may be provided to the receiving firm at a later stage by the transmitting firm, but it must be within the timing requirements specified in the transmission agreement and, in any case, in enough time for the receiving firm to meet the T+1 transaction reporting deadline. ESMA also explained that where a non-MiFID firm was transmitting an order, it would be outside the scope of Article 26 of MiFIR and, therefore, with no need to transaction report nor pass on the details to the receiving firm. The receiving firm would only be obliged to report the non-MiFID firm as its counterparty/client.

SIMPLIFIED APPROACH TO TRANSACTION REPORTING

In the Consultation Paper, ESMA recognises that transaction reporting under MiFIR will increase further the level of complexity already required under MiFID. Therefore, it proposes to simplify the requirements as much as possible by replacing the “buy/sell” indicator and “counterparty” and “client” fields with a “buyer” field and a “seller” field. In addition, the field for “trading capacity” will remain but will be independent of the determination of who is buying and who is selling. The same applies to the “reporting firm” field which will also be independent going forward. ESMA provides a series of practical examples in the Consultation Paper and believes that this new approach will reflect more closely the data maintained within firms’ trading records.

TABLE OF FIELDS

The May Discussion Paper provided a table of fields to offer firms an indication of the type of fields which would be reportable under Article 26 of MiFIR. Annex 1 of RTS32 now provides a complete list of the reporting fields required to be populated. Respondents to the May Discussion Paper were particularly concerned that the transaction reporting information requirements under Article 26 of MiFIR were aligned with EMIR as much as possible and ESMA has endeavoured to manage this in the draft RTS. Respondents also requested further clarity and details of what was expected to be populated in the transaction report fields with regard to content and format. ESMA has included further information on the format for each field. However, ESMA notes that it is still considering the details of the contents of each field and welcomes further feedback.

a) Trading capacity

The May Discussion Paper discussed the notions of principal and agency capacity to be reported in transaction reports. Following feedback from respondents, ESMA has clarified these notions in the text of RTS32. A reporting firm will now have three options to choose from when reporting in what capacity it executed the transaction, including “principal”, “matched principal” and “agent”. The Consultation Paper explains the thinking behind these new definitions in more detail.

b) Client identification

ESMA has been mandated to draft RTS which specify details of the identity of the client and a designation to identify the clients on whose behalf the investment

firm has executed the transaction. For natural persons, ESMA proposes using a person's nationality as a starting point in line with the requirements of Article 6 of RTS32 and then referring to the table provided in Annex 1 of RTS32, which sets out further detailed identifiers and priorities, including specific concatenated codes to be used where necessary (Article 6(6) RTS32). ESMA acknowledges that the requirements on firms to collect additional personal data on natural persons will be an added burden, but stresses that it is required to enable competent authorities to conduct effective monitoring for market abuse.

For legal entities, ESMA intends to require the use of a Legal Entity Identifier (LEI) for identification in transaction reports and this is set out in Article 5 of RTS32. It has dropped its original proposal to allow Business Identifier Codes (BICs) or national identifiers to be used. On the identification of joint accounts, ESMA re-iterates in the Consultation Paper that there will be more than one relevant client in such cases, and competent authorities need to receive information on both the "decision maker" and the "beneficiary" for a given trade account. It also acknowledges that data protection in relation to handling and retaining this information is a key issue. ESMA will ensure full compliance with the data protection law for the transaction reporting obligations set out in the draft RTS. With regard to data from non-EEA firms, ESMA states that the European Commission must provide clarification.

c) Trader ID and Algo ID

Firms making transaction reports will be required under Article 26(3) MiFIR to disclose the persons and computer algorithms within the investment firm responsible for the investment decision and the execution of the transaction. Respondents to the May Discussion Paper argued that ESMA's proposals to assign Trader IDs and collect additional data was excessive, but ESMA proposes to continue with its approach set out in that paper. However, ESMA has limited the amount of information required to be reported under Article 7 of RTS32 to just the identifier of the relevant trader. Where investment decisions are taken by committee, ESMA proposes that firms should assign a separate unique Trader ID to each committee. Where committees are formed ad-hoc, the ID of the individual trader taking primary responsibility for the decision to trade should be reported, rather than creating a committee ID. ESMA also proposes that, as a general rule, the person executing the trade should be identified. Where there is a chain of traders involved, the last person in the chain should be identified.

With regard to the requirement to identify the algorithm responsible for the investment decision under Article 8 of RTS32, ESMA has decided to retain the approach of identifying separately both the investment decision algorithm and the execution algorithm as set out in the May Discussion Paper. It has decided against imposing stricter requirements regarding naming conventions and identification of algorithms, since this would impose an additional unnecessary burden on the industry.

d) Identification of trade waivers

In the May Discussion Paper ESMA proposed, for transaction reporting purposes, to identify each situation in which pre-transparency obligations may be waived under Articles 4 and 9 of MiFIR with an appropriate flag. ESMA confirms this

under Article 9 of RTS32 and believes that investment firms should populate the appropriate fields of the transaction report with the information requested in Table 1 of Annex 1 of RTS32. In addition, ESMA believes that EEA trading venues will provide their members with the necessary information on waivers to allow these investment firms to populate the correct fields. ESMA also confirms that waiver flags will only be required for transaction reports relating to direct executions on the trading venue.

REPORTABLE INSTRUMENTS

The transaction reporting obligation applies to those classes of instruments listed under Article 26(2) MiFIR. ESMA was mandated to draft RTS to specify the relevant categories of instrument to be reported, and its May Discussion Paper focussed on issues surrounding financial instruments where the underlying is an index or a basket composed of financial instruments traded on a trading venue. ESMA proposes that all instruments based on indices which include at least one component that is a financial instrument admitted to trading or traded on a trading venue in their composition should be reportable. Financial instruments based on a basket should be reportable as soon as at least one component of the basket is a financial instrument which is admitted to trading or traded on a trading venue. The identification of baskets should rely on their decomposition into underlying financial instruments, which should be included in the report in the "underlying" field. ESMA confirms that non-reportable instruments should not be included.

REPORTING BY BRANCHES

Under MiFID II, the competent authority of the host Member State in which a branch of an investment firm is located has responsibility for ensuring that services provided by the branch in that territory comply with the reporting obligation. In its May Discussion Paper, ESMA proposed that branches should meet this obligation to report by including relevant reporting information in transaction reports which their head office would then report to their home Member State competent authority. The home Member State competent authority would then be able to route all relevant transaction reporting information to any other competent authorities itself. ESMA confirms this approach in the Consultation Paper and sets out the requirements in Article 13 of RTS32.

However, the Consultation Paper recognises the need to provide clear criteria through which branches and investment firms may determine whether activity is conducted by the branch or head office of the firm. Therefore, it has proposed including a field for a client to indicate whether the branch has the primary relationship with the client, and one to capture whether the investment decision was made by a trader or committee in the branch or head office. Broadly, ESMA proposes that a trader or committee will be a trader or committee at a branch when the branch has supervisory responsibilities for them. Where more than one branch or a branch and the head office are involved in a transaction, the transaction report must consolidate the activity- there should not be any duplicate reports.

TRANSACTION IDENTIFIERS AND LEIS

Following feedback on the May Discussion Paper, ESMA confirms that it will restrict the use of the Report Matching Number, conceived to identify strings of transactions, by only requiring one for two reports for transactions executed on a trading venue. ESMA also proposes that the Transaction Reference Number be retained to ensure that every transaction report sent to a competent authority at investment firm level is uniquely identified.

ESMA also confirms that investment firms must put in place appropriate arrangements to collect and verify the LEI provided by a client prior to the provision of the relevant investment service resulting in an obligation to submit a transaction report. The procedure for this is set out at Article 12 of RTS32. The firm must also ensure that the client may only execute transactions upon disclosure and authentication of its LEI.

METHODS AND ARRANGEMENTS TO REPORT TRANSACTIONS

Under Article 26(7) MiFIR investment firms and trading venues have an obligation to ensure the accuracy, confidentiality and security of all transaction reporting data; to identify and correct inaccurate data; and to ascertain whether any reports which should have been made are missing. Article 14 of RTS32 sets out the requirements in this regard and also includes further detail on consistency of the contents for reports. ESMA confirms in the Consultation Paper that over reporting should be limited as far as possible, and that it is a firm's responsibility to determine which financial instruments are reportable.

THE RELEVANT COMPETENT AUTHORITY FOR A GIVEN FINANCIAL INSTRUMENT

MiFID II sets out rules to determine the relevant competent authority for a given financial instrument. National competent authorities use the rules to route transactions received by their systems to other national competent authorities, and investors use them to establish where they need to report their short positions. The Consultation Paper confirms that ESMA will continue largely to use the rules currently in force under the original MiFID for those instruments covered under that Directive, and sets out the determination process for the following categories of instrument: equity and equity-like instruments; debt instruments; derivatives; and all other types of financial instruments. However, within these rules ESMA has also introduced new ones for the instruments not previously covered by the MiFID regime, including debt instruments issued by a non-EEA entity and derivatives where the ultimate underlying has no global identifier (for example commodities), is a basket or is a non-EEA index.

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